

TRADE AND DEVELOPMENT REPORT, 2007

**Regional
cooperation
for development**



UNITED NATIONS

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TRADE AND DEVELOPMENT REPORT, 2007

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FOREWORD

Over the past five years, the expansion of the world economy and trade has served as an engine of growth for many developing countries and helped to support progress to the Millennium Development Goals. Even the poorest countries have been able to reap benefits from sustained growth of the world economy, largely because of favourable price developments in many primary commodities. Thus the global external environment for development has strongly improved since the turn of the Millennium.

But as the *Trade and Development Report 2007* points out, this beneficial environment has some unsettling features, such as persistent imbalances and net capital flow from developing to developed countries. If we are to avert serious negative repercussions for economic growth and development, major deficit and surplus countries must work together to address these issues.

For developing countries, the most important challenge is to translate recent gains into lasting progress through successful integration into the global economy. Appropriate policies at the national level are crucial. So are efforts to bring multilateral trade negotiations to a successful conclusion, with a strengthened development dimension in international trade rules. But at the regional level, too, collective and coordinated responses can offer additional possibilities for improving growth and structural change in the globalizing world. By working together more closely and building on common and complementary interests, partners in the same geographical region can significantly strengthen their efforts to meet the challenges of globalization. The *Trade and Development Report 2007* examines the role that such cooperation can play.

In recent years, policymakers in developing countries have paid increasing attention to regional cooperation and integration in support of national development efforts. The assessments and policy proposals presented in this *Trade and Development Report* are likely to meet with considerable interest, and make a valuable contribution to the debate on how best to make regional cooperation work for development.

Ban Ki-moon
Secretary-General of the United Nations

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Explanatory notes

Classification by country or commodity group

The classification of countries in this *Report* has been adopted solely for the purposes of statistical or analytical convenience and does not necessarily imply any judgement concerning the stage of development of a particular country or area.

The major country groupings used in this *Report* follow the classification by the United Nations Statistical Office (UNSO). They are distinguished as:

- » Developed or industrial(ized) countries: the countries members of the OECD (other than Mexico, the Republic of Korea and Turkey) plus the new EU member countries and Israel.
- » The category South-East Europe and Commonwealth of Independent States (CIS) replaces what was formerly referred to as “transition economies”.
- » Developing countries: all countries, territories or areas not specified above.

The terms “country” / “economy” refer, as appropriate, also to territories or areas.

References to “Latin America” in the text or tables include the Caribbean countries unless otherwise indicated.

References to “sub-Saharan Africa” in the text or tables include South Africa unless otherwise indicated.

For statistical purposes, regional groupings and classifications by commodity group used in this *Report* follow generally those employed in the *UNCTAD Handbook of Statistics 2006–07* (United Nations publication, sales no. E/F.07.II.D.2) unless otherwise stated.

Other notes

References in the text to *TDR* are to the *Trade and Development Report* (of a particular year). For example, *TDR 2006* refers to *Trade and Development Report, 2006* (United Nations publication, sales no. E.06.II.D.6).

The term “dollar” (\$) refers to United States dollars, unless otherwise stated.

The term “billion” signifies 1,000 million.

The term “tons” refers to metric tons.

Annual rates of growth and change refer to compound rates.

Exports are valued FOB and imports CIF, unless otherwise specified.

Use of a dash (–) between dates representing years, e.g. 1988–1990, signifies the full period involved, including the initial and final years.

An oblique stroke (/) between two years, e.g. 2000/01, signifies a fiscal or crop year.

A dot (.) indicates that the item is not applicable.

Two dots (..) indicate that the data are not available, or are not separately reported.

A dash (-) or a zero (0) indicates that the amount is nil or negligible.

A plus sign (+) before a figure indicates an increase; a minus sign (-) before a figure indicates a decrease.

Details and percentages do not necessarily add up to totals because of rounding.

Abbreviations

ACP	African, Caribbean and Pacific (group of countries)
ADB	Asian Development Bank
AfDB	African Development Bank
CAFTA	Central American Free Trade Area
CIS	Commonwealth of Independent States
COMECON	Council for Mutual Economic Assistance (or CMEA)
EC	European Commission
ECA	Economic Commission for Africa
ECE	Economic Commission for Europe
ECLAC	Economic Commission for Latin America and the Caribbean
ECSC	European Coal and Steel Community
EEC	European Economic Community
EMU	European Economic and Monetary Union
EPA	economic partnership agreement
EU	European Union
EURATOM	European Atomic Energy Community
FDI	foreign direct investment
FTA	free trade agreement
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GNP	gross national product
IDB	Inter-American Development Bank
IMF	International Monetary Fund
IP	intellectual property
IPR	intellectual property right
ISIC	international standard industrial classification
IT	information technology
LIBOR	London interbank offered rate
MDG	Millennium Development Goal

MFN	most-favoured nation
NIE	newly industrializing economy
ODA	official development assistance
OECD	Organisation for Economic Co-operation and Development
PPP	purchasing power parity
PTA	preferential trade agreement
R&D	research and development
REER	real effective exchange rate
RTA	regional trade agreement
SDR	special drawing right
SME	small and medium-sized enterprise
TDR	Trade and Development Report
TNC	transnational corporation
TRIMs	trade-related investment measures (also a WTO Agreement)
TRIPS	trade-related aspects of intellectual property rights (also a WTO Agreement)
UN COMTRADE	United Nations Commodity Trade Statistics Database
UN/DESA	United Nations Department of Economic and Social Affairs
UNCTAD	United Nations Conference on Trade and Development
WIR	World Investment Report
WTO	World Trade Organization

List of regional blocs and membership

AFTA	ASEAN Free Trade Area ASEAN member States
ANCOM	Andean Community of Nations (Comunidad Andina de Naciones) Bolivia, Colombia, Ecuador, Peru, Venezuela (Bolivarian Republic of) (until 2006)
ASEAN	Association of Southeast Asian Nations Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, Viet Nam
ASEAN+3	Association of Southeast Asian Nations +3 ASEAN plus China, Japan and the Republic of Korea
CACM	Central American Common Market (Mercado Común Centroamericano) Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua
CARICOM	Caribbean Community Antigua and Barbuda, Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Haiti, Jamaica, Montserrat, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, Suriname, Trinidad and Tobago
CEMAC	Economic and Monetary Community of Central Africa (Communauté Economique et Monétaire de l'Afrique Centrale) Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea, Gabon
CFA franc zone	Coopération Financière en Afrique Centrale/Communauté Financière Africaine CEMAC and UEMOA member States
CIS	Commonwealth of Independent States Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Republic of Moldova, Russian Federation, Tajikistan, Turkmenistan, Ukraine, Uzbekistan
CMA	Common Monetary Area Lesotho, Namibia, South Africa, Swaziland
COMESA	Common Market for Eastern and Southern Africa Angola, Burundi, Comoros, the Democratic Republic of the Congo, Djibouti, Egypt, Eritrea, Ethiopia, Kenya, the Libyan Arab Jamahiriya, Madagascar, Malawi, Mauritius, Rwanda, Seychelles, Sudan, Swaziland, Uganda, Zambia, Zimbabwe
EAC	East African Community Kenya, the United Republic of Tanzania, Uganda
ECCAS	Economic Community of Central African States Angola, Burundi, Cameroon, Central African Republic, Chad, Congo, the Democratic Republic of the Congo, Equatorial Guinea, Gabon, Rwanda, São Tomé and Príncipe
ECCU	Eastern Caribbean Currency Union Anguilla, Antigua and Barbuda, Dominica, Grenada, Montserrat, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines
ECO	Economic Cooperation Organization Afghanistan, Azerbaijan, Iran (Islamic Republic of), Kazakhstan, Kyrgyzstan, Pakistan, Tajikistan, Turkey, Turkmenistan, Uzbekistan
ECOWAS	Economic Community of West African States Benin, Burkina Faso, Cape Verde, Côte d'Ivoire, Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Niger, Nigeria, Senegal, Sierra Leone, Togo

EU-15	European Union-15 Austria, Belgium, Denmark, Germany, Greece, France, Finland, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, the United Kingdom
EU-25	European Union-25 EU-15 plus Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia
EvrAzES	Eurasian Economic Community Belarus, Kazakhstan, Kyrgyzstan, the Russian Federation, Tajikistan and Uzbekistan
EU	European Union EU-25 plus Bulgaria and Romania
GCC	Gulf Cooperation Council Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates
IOC	Indian Ocean Commission Comoros, Madagascar, Mauritius, Reunion (France), Seychelles
LAIA	Latin American Integration Association (Asociación Latinoamericana de Integración) Argentina, Bolivia, Brazil, Cuba, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay, Venezuela (Bolivarian Republic of)
MERCOSUR	Southern Common Market (Mercado Común del Sur) Argentina, Brazil, Paraguay and Uruguay
NAFTA	North American Free Trade Agreement Canada, Mexico, United States
OECS	Organisation of Eastern Caribbean States ECCU plus British Virgin Islands
SAARC	South Asian Association for Regional Cooperation Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, Sri Lanka
SACU	Southern African Customs Union Botswana, Lesotho, Namibia, South Africa, Swaziland
SADC	Southern African Development Community Angola, Botswana, the Democratic Republic of the Congo, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, South Africa, Swaziland, the United Republic of Tanzania, Zambia, Zimbabwe
SAFTA	South Asian Free Trade Agreement SAARC member States
UEMOA	West African Economic and Monetary Union (Union Economique et Monétaire Ouest Africaine) Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, Togo
UMA	Arab Maghreb Union Algeria, the Libyan Arab Jamahiriya, Mauritania, Morocco, Tunisia
WAMZ	West African Monetary Zone Gambia, Ghana, Guinea, Nigeria, Sierra Leone

OVERVIEW

Global economic trends envisage a continued expansion of the world economy

In 2007, for the fifth consecutive year, the expansion of the world economy is expected to maintain its momentum with an estimated overall output growth of 3.4 per cent. Thus developing countries, including many of the poorest, should continue to benefit from strong demand for primary commodities. In many developing countries, including in Africa, positive trends in the terms of trade since 2003 have contributed to improved external and fiscal balances. These have paved the way for more expansionary policies, and for a widespread recovery in investment rates. Africa is set to continue growing at around 6 per cent in 2007, while growth rates in Latin America and West Asia are expected to slow down slightly to close to 5 per cent. Indeed, over the past five years, per capita GDP in Africa, West Asia and Latin America has increased by more than 15 per cent, a rate not seen in these regions since the early 1980s. This certainly raises hopes for greater progress towards meeting the United Nations Millennium Development Goals. However, it has to be noted that not all developing countries have experienced improvements in their terms of trade, because they have to contend with higher oil import bills while the prices of the products they export have not increased at similar rates.

Once again, the fastest growing regions of the world economy will be East and South Asia, due mainly to the strong performances of China and India. Given their high investment ratios, this pattern is likely to continue in the years to come, provided that the inevitable correction of global imbalances does not occur at the expense of a major recession in the United States, one of the largest markets for Asian exports. There are some signs of a slight shift in the sources of world economic growth, with the United States economy slowing down and domestic demand in Europe and Japan recovering.

The performance of developing countries and their potential for catching up with the developed countries has improved considerably. Although enormous differences in absolute incomes persist, developing countries increased per capita GDP by almost 30 per cent between 2003 and 2007, compared to 10 per cent in the G-7 countries. Real per capita income has picked up in recent years in Latin America, Africa and West Asia after more than two decades of stagnation. In East and South Asia economic growth accelerated from already high growth rates, which allowed these subregions to more than double their per capita GDP in only 14 years. The transition economies of South-East Europe and the CIS returned to growth in 1999–2000. Since then, they have been the most rapidly growing subregions, with an accumulated increase in per capita income of almost 75 per cent. However, this

recovery has come after such a deep depression that current per capita GDP is still below its level of 1989. In 2007, six years after the start of global recovery, less than 10 out of 143 developing countries are set to record a fall in real per capita income. At the same time, the volatility of growth has declined to levels normally observed only in highly developed economies.

In this favourable external economic climate, most developing economies have seen strong growth in employment or have succeeded in stabilizing or slightly reducing unemployment rates, and this despite the fact that open unemployment in developing countries is much less responsive to high growth rates than it is in developed countries. The unemployment rate has fallen visibly only in Latin America. In Asia, where the level of unemployment varies considerably among the different subregions, the rates have remained more or less stable, while sub-Saharan Africa has seen a minor decline. The main reason for the low impact of growth on open unemployment in many developing countries and emerging market economies could be the huge reserves of labour that enter the formal economy only after a longer phase of rising demand for labour and increasing wages. As some emerging countries – including China – show, the process of integrating such reserves of labour into more formal labour markets may take many years of fast growth. But if the gains of strong productivity growth spread equally to wage earners and to companies, the resulting consumption boom should further stimulate growth and enhance the opportunities for low-paid workers in the informal economy to find decent employment in the formal economy.

Growing exports and net capital outflows from developing countries

The dynamics of overall growth in developing countries have been stimulated by strong growth in export revenues. Real exports of developing economies more than doubled between 1998 and 2006, whereas those of the G-7 rose by less than 50 per cent. Among the developing regions, East and South Asia were clearly the most successful in increasing exports (by volume), at a rate of about 160 per cent, despite a deterioration in their terms of trade. In other developing regions, export volumes grew at a more moderate pace, close to that of the G-7, but gains from the terms of trade boosted the purchasing power of their exports, and consequently their imports. Overall, the share of developing countries in global trade rose from 29 per cent in 1996 to 37 per cent in 2006.

As a consequence of this favourable trade performance, the overall current account of developing countries has swung into a surplus for the first time since the early 1970s, and that of developed economies is in deficit, mainly due to the huge deficit of the United States. This positive swing could be observed in most developing regions and in the transition economies. For example, in 1996–1997, South America, South-East Asia and the transition economies posted significant deficits, and East Asia and West Asia were close to balance; all of them now have solid current-account surpluses.

As a result, a number of developing countries have become net exporters of capital on such a scale that there has been a net aggregate capital outflow from developing countries. But this has not been a constraint on domestic capital formation. Indeed, while real investment in the G-7 countries remained rather flat (and investment/GDP ratios declined), many developing economies were able to trigger an investment recovery once their financial crises were overcome. The sustained net capital exports from the poorer developing countries to the capital-rich developed countries raises doubts

about the validity of orthodox development theory in the new global context, and points to the need for a rethinking of the most crucial assumptions about the functional relationships between savings, investment, capital flows and alternative policies and catch-up paths.

Global imbalances still awaiting a solution

The sources, sustainability and possible adjustment of the widening imbalances in the world economy have triggered one of the liveliest and more controversial economic policy debates of the past few decades. For some observers and politicians, the fact that imbalances correspond to a real transfer of resources from surplus to deficit countries is just a natural and harmless consequence of an increasingly integrated global economy.

Others believe that the size of any transfer of resources, be it to individuals or to nations, should remain reasonably related to the expected long-run ability of individuals or nations to pay interest and amortization. Therefore the substantial net capital flows in one direction over many years is indicative of a fundamental problem with the allocation of capital in the world economy since the aftershocks of the big financial crises in Asia, Latin America and some transition economies. From this perspective, adjustment is imminent and can be either “soft”, involving a smooth correction through government intervention, or “hard”, involving a painful contraction and crisis in deficit countries with major adverse repercussions for surplus countries.

Undoubtedly, the overall competitiveness of an economy that runs a persistent deficit or surplus is a decisive factor influencing the sustainability of the trade or current-account balance. Indeed, in the past, large corrections of deficits usually went hand in hand with huge devaluations of the nominal and real values of the currencies affected. Empirical evidence has shown that changes in the real effective exchange rate (REER), the most comprehensive measure of the overall competitiveness of countries, have the potential to reduce deficits or to cause swings in the trade and current account from deficit to surplus, because they induce an expenditure switch between demand for domestic and foreign goods.

Thus an increasing current-account surplus accompanied by a real devaluation (i.e. a “false” price movement) must be taken as a much stronger indication of non-sustainability than a surplus accompanied by a tendency towards real appreciation. The Japanese yen, for example, rather than appreciating as could be expected due to the strong Japanese competitive position and a huge current-account surplus, has depreciated in recent years – in both nominal and real terms – vis-à-vis the currencies of Japan’s major trading partners, thereby further increasing the competitiveness of Japanese exporters. And there are other cases where exchange-rate changes have moved in a wrong direction. Indeed, compared to 1996, of all the world’s large economies and countries with the biggest surpluses, only China has experienced a slight appreciation of its REER, and thus a slight deterioration in its competitive position. In the other three countries with the largest surpluses – Japan, Germany, and Switzerland in particular – which are all officially adhering to “free floating” regimes, the real value of their currencies has actually fallen (their competitiveness has increased), further lowering the prices of their products on the world market.

This paradox deserves greater attention than has hitherto been accorded in the debate about remedies for global imbalances, even if the reasons for the real depreciation of currencies vary. In

Germany, the real depreciation compared to the mid-1990s can be attributed to very slow growth in nominal wages. This has driven unit labour costs lower than the levels of its main trading partners, both inside and outside the euro area, despite an appreciation of the euro against the dollar. In the case of the yen and the Swiss franc, their real depreciation can be explained by so-called “carry trades”, which occur when there are large differences between the expected nominal return and the real return on investments.

This is not a new phenomenon: most of the financial crises in the post-Bretton Woods era of floating currencies were preceded by a build-up of nominal interest rate differentials, which were not covered by immediate depreciation (so-called uncovered interest rate speculation). What is new is that big institutional portfolio investors like hedge funds are able to trigger a long-lasting appreciation in the real exchange rate of a country with a higher nominal interest rate, and thereby increase the return on their investments through their own behaviour. Moreover, if central banks attempt from the outset to limit the extent of appreciation of the domestic currency through intervention in the foreign-exchange market, the resulting growing stock of foreign currency reserves only reduces the risk for international speculators.

The ongoing carry trade from yen or Swiss francs – currencies of countries with very low inflation and very low nominal interest rates – to countries with higher inflation and higher interest rates like Brazil, New Zealand or Hungary breaks the vital link between interest rate differentials (and inflation rate differentials) and the risk of currency depreciation, a link that is crucial for the long-term equilibrium of the global trading system. If the financial markets systematically distort the competitive positions of nations and companies, policy intervention is unavoidable, sooner or later. Unhedged borrowing by hedge funds and other speculators raises the question as to whether a floating regime is the only feasible solution to the problem of the external balance and a buffer against external shocks.

In this context, political pressure on China to float its currency may be counterproductive. Floating of the Chinese currency may yield exactly the opposite of the expected result. As China’s interest rates are still rather low, the renminbi could follow the examples of the yen and Swiss franc, with Chinese assets being carried to high interest rate locations. This would result in a depreciation of the renminbi, which would further increase China’s competitiveness instead of reducing it – an outcome that would worsen global imbalances even more.

External regimes and fixed investment

Large returns on uncovered interest rate speculation penalize international competitiveness and capital formation through two channels: the real exchange rate and the real interest rate. Empirical evidence shows that the existence of uncovered interest returns (i.e. returns that carry the risk of exchange-rate changes) tends to reduce international competitiveness and increases the cost of capital for domestic investors in fixed capital.

Only a few countries – Japan and Switzerland being outstanding examples – can afford largely to ignore changes in the exchange rate and keep nominal (and real) interest rates at a very low level without the risk of accelerating inflation. However, this behaviour induces high margins in speculation with uncovered returns, and it provokes the real appreciation of currencies elsewhere. In the case of

Japan, this is due to the deflationary risks that are fuelled by very low or negative growth rates of wages. The open capital market and the extremely low interest rate invite speculation to drive the yen down and other currencies up.

For Brazil, Mexico, South Africa, Turkey and Hungary, countries which have recently adopted inflation targets for monetary policy that typically require a free floating currency and control of the inflation rate through interest rates, the results have been disappointing. Although the post-devaluation regime usually marked a deep structural change for these countries, with a shift towards more credible monetary policies, interest rates and volatility are still very high, and the tendency towards real appreciation and deterioration in overall competitiveness persists. Additionally, the high real interest rate, systematically higher than in the United States or other large industrialized countries, constrains capital accumulation and catch-up.

For middle-income Asian countries, such as Indonesia, Thailand and the Republic of Korea, the regime change from soft peg to float following their crises has also been associated with larger exchange-rate volatility and a tendency towards real appreciation. Only China, with its specific pattern of strict intervention in the currency market to fix the exchange rate and negative real interest rates, has succeeded in maintaining a high degree of stability and very low costs of capital, which is extremely favourable to the creation of capital through fixed investment.

Policy options

For small open economies, and developing countries in particular, a stable and prospering external sector is crucial, which is why the exchange rate is the most important single price in these economies: it influences overall competitiveness and has a strong impact on national price levels. To avoid the fight for market shares through manipulation of exchange rates, wage rates, taxes or subsidies, and to prevent the financial markets from driving the competitive positions of nations in the wrong direction, the globalized economy may need a new code of conduct to govern overall competition between nations.

Such a code of conduct, as part of the global governance system, would have to balance the advantages of one country, accruing from a constellation of changes in real exchange rates, against the disadvantages of others that are directly or indirectly affected. For example, changes in the nominal exchange rate that deviate from the fundamentals, and which do not merely reflect inflation differentials, affect international trade in a similar way as changes in tariffs and export subsidies. Consequently, changes in the real exchange rate should be subject to multilateral oversight and disciplines. Reasons for a deviation from the fundamentals and the necessary dimension of the deviation could be identified. If appropriate exchange-rate rules were established, unjustified losses or gains in overall competitiveness could be prevented. Developing countries could thereby systematically avoid overvaluation, which has been one of the greatest impediments to sustained prosperity in the past.

In the absence of such an arrangement, developing countries need flexibility for managing their exchange rates and a sufficient number of instruments to prevent excessive volatility in the external sector in order to improve their prospects for long-term investment and successful catching up. Empirical evidence belies the orthodox belief that with free-floating regimes international financial markets can

do that job by smoothly adjusting exchange rates to their “equilibrium” level, and that with fixed exchange rates, product, financial and labour markets would always be flexible enough to smoothly and rapidly adjust to a new equilibrium. In reality, exchange rates under a floating regime have proved to be highly unstable, leading to long spells of misalignment, with disastrous consequences for the real economic activity of the economies involved. The experience with hard pegs has not been satisfactory either; since it has not been possible to correct the exchange rate in response to external shocks or misalignment, adjustments have been costly in terms of lost output, and the real sectors of the domestic economy have borne the brunt.

A strategy of providing policy space and control over the relevant monetary instruments can only be replaced by multilateral oversight and surveillance if the leading industrialized economies are willing to play a more proactive role in steering the international monetary system, including through direct intervention, to enable orderly depreciations for countries in trouble. Past experience has demonstrated that developing countries with strong current-account positions are able to avoid destabilizing capital inflows and outflows either by taxing those flows or by limiting their impact through direct intervention in the market. In these cases, the hardest choices and the gravest misallocations due to erratic exchange-rate changes have been avoided. But neither the resort to controls nor to permanent intervention can be a substitute for an appropriate exchange-rate system at the regional or – preferably – the global level.

In light of the dim prospects for such a solution at the global level, initiatives for monetary cooperation at the regional level have received increasing attention in recent years. On the one hand, this is a reaction to the gaps between the original ideas and the actual outcome concerning the reform of the international financial architecture; on the other hand, it is also part of the broader trend towards “regionalism” aimed at strengthening national development strategies.

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Globalization and regionalization

Regional cooperation among developing countries has the potential to support national development strategies, and to some extent fill the gaps in the global economic governance system. But in order to do so it has to extend beyond trade liberalization to include policy areas that strengthen the potential for growth and structural change in developing countries. These include macroeconomic and financial management, as well as trade support and industrial policies. There appears to be an untapped potential for closer regional cooperation among developing countries in these areas, which could also add policy options to those available at the national level. On the other hand, the trend towards North-South bilateral or regional trade agreements, resulting from a sense of frustration of some governments with the slow progress in multilateral trade negotiations and an attempt to advance liberalization in areas that are not subject to these negotiations, threatens the coherence of the multilateral trading system. It also threatens the viability of existing regional cooperation arrangements among developing countries, and, most importantly, the options available to these countries for pursuing their national development strategies.

Economic integration within a national economy is associated with expanding domestic markets, a shifting pattern of employment away from rural activities and an increasing industrial division of labour that leads to a dense network of input-output linkages between sectors. Strong national institutions are also required to forge the socio-political consensus needed to mobilize and channel resources into productive investment and to manage the trade-offs incurred along a dynamic development path, including those arising from increased external integration. Developing countries seek to integrate into the world economy in the expectation that this will help accelerate output growth and productivity and improve living standards through increased trade, technology and capital flows. In order to be able to derive such benefits from external integration, similar conditions have to be fulfilled as for internal integration: they must have a certain level of local production capacity, skills and technological sophistication, an array of market supporting institutions and good infrastructure.

But with the increasing interdependence of national economies in a globalizing world, national development increasingly depends on the external environment and on coherent structures in the international monetary and financial systems. Last year's *Trade and Development Report* suggested that multilateral structures needed to be more inclusive and flexible if gains from closer integration into the world economy were to be more widely shared. And, as suggested above, new multilateral disciplines are necessary, particularly in the area of international finance, to achieve more balanced outcomes. However, multilateral arrangements are not the only option for fashioning collective and coordinated responses to the challenges confronting developing countries in an increasingly interdependent world economy. Indeed, following the failure of the international financial institutions to manage the financial shocks and crises towards the end of the 1990s, and given the slow progress of the Doha Round of multilateral trade negotiations, regional arrangements have assumed a more prominent place on the international development agenda.

Regional economic cooperation occurs in various forms and degrees, and is in general aimed at increasing cross-border linkages and deepening interpenetration of economic activity for the mutual

benefit of economies within a geographic region. A distinction is frequently made between policy-induced integration, which is also called regionalism and involves formal economic cooperation arrangements, and market-driven integration, also termed regionalization, which is spurred by regional growth dynamics, the emergence of international production networks and related FDI flows. Recognizing that multilateral disciplines could lead to a narrowing of national policy space for developing countries, regional economic cooperation can provide some means to help countries cope better with globalization. From this perspective, regional institutions could fill gaps in global economic governance structures. The form that such cooperation takes will depend not only on the specific historical, geographical and political circumstances in a region, but also on the relative weight given to market forces and State intervention – a choice that can influence economic policies at the national and global levels.

Over the past two and half decades these policies have been based on the belief that market liberalization and opening up to international trade and finance would lead to the best possible factor allocation in general, and raise productivity and accelerate technological upgrading in developing countries, in particular. This tendency to give priority to market forces in determining factor allocation is reflected in the rapidly increasing number of regional and bilateral free trade agreements (FTAs) or preferential trade agreements (PTAs) concluded since the early 1990s.

The “new regionalism”

The number of trade agreements notified to the GATT/WTO increased from 20 in 1990 to 86 in 2000 and to 159 in 2007. The agreements concluded over the past 20 years have been mainly bilateral, and primarily between developing and developed countries. They have increasingly included provisions aimed at “deep integration”, which involves additional elements for harmonizing national policies in line with a reform agenda that favours greater freedom for market forces – thus also promoting the freedom of movement of TNCs – and reduces options for government intervention. This trend, combined with the increasing number of FTAs and RTAs involving countries from different geographical regions, characterizes what has come to be labelled as “new regionalism”. This term is somewhat misleading, since most of the trade agreements are bilateral and involve countries that are not necessarily in the same geographical region.

“New regionalism” denotes a departure from multilateralism, and has grown out of a sense of frustration of some governments at the slow progress in multilateral trade negotiations. It stems from their belief that a number of bilateral “regional” agreements could serve as a better vehicle for advancing their preferred agenda of economic liberalization and harmonization across a broad range of policies, laws and institutions aimed at promoting the internationalization of investment and production. In a way, this “new regionalism” bypasses multilateral institutions and arrangements, as governments pursue economic objectives and use instruments for which no agreement has been reached at the multilateral level. At the same time, it reflects the tendency to perceive globalization as a process whereby access to markets of the North and attracting FDI from developed-country investors is key to successful integration into the world economy.

The WTO report, *The Future of the WTO*, criticized this proliferation of bilateral and regional trade agreements on the grounds that it has made the most-favoured-nation (MFN) principle the exception rather than the rule, and has led to increased discrimination in world trade. However,

negotiations on FTAs have continued to progress. The United States has been the most energetic in negotiating FTAs, particularly with developing countries. The EU, too, already has bilateral FTAs in various forms with developing countries in all regions, as well as with economies in transition, and it plans to conclude more of them. Japan has been involved in bilateral trade negotiations with several countries in the Asia-Pacific region; and other developed and developing economies, such as the European Free Trade Association, Australia, Chile, China, Mexico, Singapore and Turkey, have also been pursuing a strategy of entering into bilateral PTAs with countries from very diverse regions.

The motivation of a developing country for concluding a bilateral agreement with a developed-country partner is to obtain concessions that are not granted to other countries, particularly better market access for its products. Indeed, bilateral North-South FTAs have the potential to provide the developing-country partner with considerable new trading opportunities, as witnessed by the sharp increase in Mexican manufacturing exports after the conclusion of NAFTA. Such FTAs may also attract more FDI to the developing-country partner. But there can also be potential disadvantages for developing countries, because such FTAs generally demand far-reaching liberalization of foreign investment and government procurement, new rules on certain aspects of competition policy, stricter rules on intellectual property rights, and the incorporation of labour and environmental standards. Moreover, many FTAs oblige developing countries to undertake much broader and deeper liberalization of trade in goods than that agreed under WTO arrangements. Some also involve a form of liberalization of services that differs from what is envisaged in WTO agreements, thus exerting pressure on developing countries to make greater liberalization commitments in this area.

Because they involve reciprocal commitments, FTAs between developed and developing countries eliminate the special and differential treatment that may be granted to developing countries in the context of other agreements. The reciprocity principle in North-South FTAs places developing countries at a disadvantage vis-à-vis their developed-country partners, as they typically enter into the liberalized trade relationship at a less advanced stage of domestic industrial development, implying lower supply and marketing capacities. Moreover, the possibilities of developing countries to benefit from the investment provisions of these FTAs are limited. In order to comply with the principle of reciprocity, developing countries are also forced to cut tariffs from significantly higher levels, especially on industrial products.

Another motivation for joining an FTA is the perceived risk of losing competitiveness vis-à-vis other developing countries that might have entered into an FTA with the same main trading partner. Indeed, unlike negotiations in a multilateral context, individual bilateral negotiations create an environment of competitive liberalization. But the benefits that developing countries can obtain in North-South bilateral negotiations are circumscribed by their usually weaker bargaining power and the limited negotiating flexibility of their developed-country partner. This is due to a combination of strong pressure from domestic lobbies and limitations imposed by existing national legislation, as in the case of the United States, or complex governance and decision-making processes, as in the case of the EU. For example, these factors have made it especially difficult for the major developed countries to accept a reduction or elimination of agricultural subsidies as a negotiable issue in bilateral agreements. Consequently, developing-country partners in bilateral trade agreements are deprived of perhaps the most important potential source of increased market access in the major developed countries. Moreover, a developing country is often unable to derive the full benefits of the improved market access opportunities of an FTA because of limited supply capacities and competitiveness, and because local firms are often unable to comply with restrictive rules of origin on goods destined for export to the developed-country partner. Finally, preferences negotiated by one developing country with a developed partner may quickly be eroded if the same developed country also concludes FTAs with other developing countries.

On the other hand, the developing country has to bear the consequences of eliminating tariffs and other trade barriers in almost all categories of goods. It gives up the possibility to use potentially

important and powerful instruments of industrial and agricultural policy, which are often indispensable for promoting the creation of new production capacities, industrial upgrading and structural change in their economies. All of these are essential for improving the developing country's supply capacity and competitiveness, which are prerequisites for maximizing the potential gains from trade liberalization. Thus the gains for developing countries from improved market access are far from guaranteed, whereas the loss of policy space is certain. It is therefore in the interest of developing countries that the multilateral trade negotiations advance, but with a stronger development dimension built into international trade rules.

Advocates of the "new regionalism" argue that FTAs and PTAs, rather than undermining the multilateral trading system, have the potential to put the multilateral negotiations back on track, precisely because they are part of a strategy of "competitive liberalization". This is because such agreements generally include provisions that extend beyond current WTO rules and regulations in areas such as investment, competition policy and government procurement, as well as in other areas that have been excluded from the agenda of the multilateral trade negotiations. Thus some observers have perceived them as locking in orthodox policy reforms. Yet such reforms have a fairly modest record in terms of enhancing growth and structural change in developing countries, and their underlying principles have come under increasing criticism.

In assessing the potential economic and social benefits and costs of entering into North-South bilateral or regional FTAs, developing countries should not only take into account the potential changes in exports and imports arising from market opening, and possible increases in FDI. They should also consider the impact of such agreements on their ability to use various policy options and instruments in the pursuit of a longer term development strategy. Rather than subscribing to the "new regionalism", which promotes the extension of TNC activities in the developing world, developing countries may examine other areas of cooperation with partners in the same geographical region, in the spirit of true regionalism. This could help strengthen their own strategies for national development and integration into the global economy, building on the advantages of proximity, similarity of interests and economic complementarity.

Regional cooperation and effective integration among developing countries

Access to a larger market as a means of achieving scale economies and diversifying production has also been a long-standing rationale for regional arrangements among developing countries. Industrial differentiation broadens the potential for expanding intra-industry trade. Among countries with similar economic structures and technological capabilities, firms that cross various thresholds in terms of size, productivity performance and technological know-how tend increasingly to trade abroad, giving rise to an interactive and cumulative process between internal and external integration. Exports allow scale economies to be further exploited, which can also attract FDI. At the same time a growing outward orientation exposes firms to new products and processes, and to new sources of competition. These considerations apply to outward orientation generally, but for many developing countries that are at an early stage of industrial development, a regional orientation involving countries at a similar level of development may be considered a more viable option. This is because the initial foreign competition within the region may be less difficult to handle, the technological gap vis-à-vis competitors

from more advanced countries outside the region may be easier to close, and the probability of finding a level playing field is greater.

Formal regional cooperation can be accompanied by very different degrees of effective regional integration, and this has sometimes occurred among countries without the prior conclusion of formal trade arrangements or other far-reaching policy cooperation. Formal agreements on trade liberalization or other forms of regional cooperation are not a precondition for *de facto* integration; in general there is a two-way dynamic interaction between the two. Once external linkages reach a certain level of intensity, there will be pressure from producers to lower or remove the various barriers to intraregional trade, including bureaucratic red tape and conflicting legal restrictions and administrative procedures, as well as demands for better transport and communications infrastructure.

In a world that does not correspond to the perfect competition model of economic theory, and where dynamic interactions between economic and politics shape the path of development, regionally coordinated or common public policies can support regional integration and faster growth. They can do this by bridging gaps left by market mechanisms and by helping to overcome constraints on industrial take-off, diversification and sustained catch-up growth that have a dimension that goes beyond national boundaries, as demonstrated by the experience of post-war Western Europe.

Areas of such active regional cooperation can include apparently simple measures, such as trade and transit facilitation and the dissemination of commercial information. But it is precisely the lack of such measures that are often a major hindrance to closer integration. Regional cooperation in the planning and financing of transport infrastructure to enable physical cross-border trade and reduce its costs is an equally important ingredient for development. Regional management and investment projects in the crucially important areas of energy and water supply, which in many developing countries represent serious bottlenecks, are other instances where regional cooperation can serve development.

Expansion of trade also requires a stable financial and monetary environment. As mentioned earlier, since the international financial system lacks sufficient instruments to reduce the volatility of international financial markets and its impact on developing countries, regional cooperation in monetary and exchange-rate policies has become an important issue. This is a concern not only in Western Europe but also in all developing regions. Indeed, in the absence of far-reaching reform of the international financial architecture, strengthened regional monetary and financial cooperation can be critical for achieving greater coherence between the international financial system and the international trading system while respecting specific developing-country interests.

International, and for that matter regional, trade should not be considered an end in itself; rather it is a means to achieving faster growth. Countries should therefore also investigate innovative areas of policy-making at the regional level that could support diversification and industrialization of their economies. This could, for example, take the form of support for industrial projects and common undertakings in research and development, knowledge generation and information dissemination, that might be too costly and risky for an individual developing country but viable if several countries were to pool their resources.

Adapting regional cooperation to globalization

National economies with a successful record of development are characterized by “adaptive efficiency”: the capacity to develop institutions that provide a stable framework for economic activity but which are flexible enough to provide the maximum leeway for policy choices in response to specific challenges. At a time when developing countries individually have reduced options for national economic policy-making, regional institutions may offer a way of extending the “adaptive efficiency” principle to cross-border relations. Globalization and the trend towards greater interdependence as a result of internationalization of investment and production decisions present new challenges. Many of these challenges cannot be dealt with exclusively at the national level and may require a similar adaptation of regional institutions, especially as multilateral institutions and policies have failed to adapt.

From this perspective, regional cooperation among developing countries involves a good deal more than the search for common ground on external policies; it also involves the provision of regional public goods and a reconfiguration of policy space. At the same time, new political challenges, including the unequal influence of members, and in particular the ability of stronger members to bypass collective agreements, will have to be dealt with. This implies that regional arrangements, as much as those of national State formation, will have to develop acceptable levels of competence, legitimacy and trust, which is likely to take time. The European experience of regional cooperation suggests that such cooperation is unlikely to follow some established blueprint, that it takes considerable time to evolve, and that the steady build-up of institutional capacity is a critical dimension of success.

Proximity and complementarity can still promote mutual interests

Regional arrangements are generally judged against a benchmark derived from standard trade models, which consider fully open borders to goods, services and FDI as prerequisites for successful development. But the underlying assumptions of these models have little to do with economic reality. They fail to consider the possibility of various kinds of market failures and the role that dynamic economic forces and geographical proximity can play in triggering and sustaining virtuous growth circles. In a world with increasing returns, external economies and variable transaction costs, proximity still offers some real economic advantages. Moreover, in the majority of existing regional cooperation agreements, political motivations and influences are an integral part of regional cooperation. From the perspective of conventional trade models, in which market incentives are key to optimal factor allocation, such motivations are inherently suspect. Yet in all healthy market economies, politics and

economics are in permanent interaction: market failures provide one point of interaction and the provision of public goods another.

There are strong links between internal market integration, intra-industry trade and the formation of regional blocs. Direct investment which usually follows (and is complementary) to these trade flows adds to these links, whereby industries in different countries of the bloc either collaborate in the creation of a single product or specialize in the production of different finished goods for export to the entire bloc or beyond. As a result of these cross-border vertical production relations, trade becomes increasingly intra-firm, intra-industry and intraregional. The key to the formation of these blocs lies with various external economies that derive from the linkage intensity of a more diversified industrial economy, and that maintain the connection between productivity and proximity. This is evidenced by the fact that, despite the process of globalization that has shaped the world economy over the past 25 years, in the larger OECD economies – and even in some of the smaller ones – most firms still produce the largest proportion of their output within national boundaries. Less than a dozen of the biggest TNCs in the Fortune 500 are truly “global” in the sense of having 20 per cent or more of their sales in each of the three large geographical trade blocs – North America, Western Europe and East Asia. Within these blocs, most firms produce most of their output within national boundaries, and, when they do trade or move abroad, most find a disproportionately large number of their markets and locations close to home.

The attitude of developing countries towards regional integration has evolved with their situation in the global economy, their experiences with globalization, and in some cases, with their changing development strategies. Tariff preferences have traditionally been a key instrument for market enlargement and industrial deepening based on the assumption that a larger regional market would increase opportunities for industrial specialization and the realization of scale economies in an otherwise protectionist international environment. Although MFN tariffs have been substantially reduced over the past 20 years as a result of progress in multilateral trade liberalization, preferential access among regional partners may still be a tool for regional trade and industrial integration, even if it is not sufficient by itself to create economic integration, which is associated with increased industrialization and diversification. And regional tariffs could still be an important means of support for sectoral policies, even if the average import tariffs remain relatively low.

Intraregional trade flows

Despite the erosion of regional tariff preferences as a result of the reduction in MFN tariffs, various indicators suggest that over the past 20 years intraregional trade in all developing regions has expanded faster than extraregional trade. This is true both for geographical regions and for regional cooperation arrangements. It may have been fostered by the harmonization of standards and the establishment of common rules through policy coordination. Intraregional trade has expanded the most rapidly among the developing countries of East Asia since the mid-1980s, and today represents almost half of that region’s total trade. In Africa, although the share of intraregional trade in its total trade has also increased, it is still less than 10 per cent of its total trade. Intraregional trade in Latin America, excluding Mexico, has grown significantly since the late 1980s, to reach close to 30 per cent of its total trade. The geographical trade pattern of the economies in transition has changed dramatically since the early 1990s, with many Central European countries increasing their trade linkages with

Western Europe, culminating in their accession to EU. Intraregional trade among the economies in transition that are members of the Commonwealth of Independent States (CIS) has been declining, but is still significant, accounting for about a quarter of that group's total trade in 2005. The "geographical bias" in favour of intraregional trade is due to a variety of factors, some of which may be related to formal integration schemes while others benefit from trade-related advantages such as proximity, lower transport costs, tacit knowledge stemming from repeated interaction, and spillovers of various kinds.

Of all developing-country regional arrangements, the Association of Southeast Asian Nations (ASEAN) displays the highest level of intraregional trade in its total trade: 25 per cent on weighted average. Although ASEAN was created as a political rather than an economic grouping, trade among its participants has consistently increased since the mid-1970s. Yet trade liberalization was formalized only in 1992 with the launching of the ASEAN Free Trade Area (AFTA). Developing countries in East and South-East Asia accounted for almost 50 per cent of total ASEAN trade in 2005, compared to only 30 per cent in 1990. This trade expansion has largely been due to the development of a wider regional production network driven by other Asian economies, in particular China, the Republic of Korea and Taiwan Province of China. Its success has encouraged negotiations for enlarging the free trade area to China, the Republic of Korea and Japan.

The pattern of development and integration in East Asia has followed some of the features of European integration, although with distinct characteristics owing to the influences and legacies of colonial rule, the economic gap between Japan and its neighbours and the specific demands of late industrialization. In the integration process, stages of industrialization and regional development have been closely interlinked. The rapid upgrading of economic activity from resource-based and labour-intensive industries to increasingly sophisticated manufactures in the leading economies opened up opportunities for their less developed neighbours to enter the regional division of labour by expanding their less demanding, lower skill, labour-intensive activities that could no longer be competitively supplied by the front runners. In this process, trade and FDI served as vehicles for "redistributing" comparative advantage, and, beginning with post-war Japan, there was a deliberate adoption of pro-investment macroeconomic policies along with strategic industrial and technology policies to serve this objective.

These trends are closely connected with the emergence of regional production networks, either involving large TNCs that produce a standardized set of goods in different locations, or groups of small and medium-sized enterprises located in different countries and linked through international subcontracting to a lead coordinating firm. Both kinds of networks exist in East Asia, although the first kind is more prevalent. China has contributed significantly to the accelerating pace of intraregional trade since the late 1980s, with large firms from the region relocating assembly operations to take advantage of lower costs, and becoming important exporters of intermediate goods to China. Participation in these networks has also been part of the development impetus in South-East Asia, though it is confined to a small number of industries.

In Latin America, formal regional cooperation agreements appear to have played a more important role than in East Asia. Both South American integration agreements, ANCOM and MERCOSUR have been accompanied by a considerable expansion of intraregional trade. But beyond these agreements trade with non-members in the geographical region has also grown faster than trade with the rest of the world, again indicating a geographical bias. However, integration in Latin America was much weaker and less stable than in East Asia with a less dynamic overall economic performance. The reasons for this can be attributed to global shortcomings as well as to inadequate national policies.

This is also partly true for Africa. African countries typically belong to several regional trade arrangements, but in few cases has this led to significant intraregional trade. With the exception of the West African Economic and Monetary Union (UEMOA), which also belongs to the CFA franc zone, and the Southern African Development Community (SADC), intraregional trade has not exceeded

5 per cent of the total trade of the members of these regional agreements. The relatively small weight of intraregional trade in Africa, despite the existence of several (and frequently overlapping) RTAs, is largely due to their production structure and the composition of their exports, as well as the presence of non-tariff barriers and infrastructural constraints. As many countries still specialize in only a small number of primary commodities for export, while most of their imports consist of manufactures, the mismatch between the structures of supply and demand in their international trade limits the potential for intraregional trade. The export-oriented production of their labour-intensive manufactures has not significantly increased their intraregional trade either, because almost all those exports go either to Western Europe or to the United States.

The product composition of intraregional trade flows

The composition of exports has a strong influence on the impact of trade on long-term growth. A comparison between the composition of intraregional and extraregional trade suggests that the former in many cases offers a considerably greater potential for export upgrading than the latter. Regional blocs of developing countries typically represent important, and in many cases dynamic, markets for the manufactured exports of their members, including those of higher skill and technology content. Regional markets generally provide a supportive economic context for local industries in the initial stages of development and are more likely to attract manufacturing FDI than smaller national markets. Thus, increasing trade within the same geographical region can be more conducive to diversification, structural change and industrial upgrading than overall trade. Geographical proximity matters as much as the initial economic structure of each country, but regional trade agreements, as well as other arrangements at the regional level that foster trade integration and greater product diversity, especially in the manufacturing sector, can enhance the positive impact of intraregional trade. Obviously, the geographical directions of external integration – intraregional, with other developing regions, or with developed countries – are not mutually exclusive: a country may benefit from expanding its exports to all these markets. However, for a developing country seeking to upgrade its production structure and the technology content of its domestic industry, an orientation towards the regional market can be an important factor for enhancing the competitiveness of domestic producers and an initial step for integrating into the wider international market.

The growing volume of intraregional trade and, more importantly from a development perspective, an increase in the relative share of manufactures and medium- and high-skilled products, provides a strong argument in favour of a development strategy that links industrialization and regionalism. However, the success of such a strategy requires active cooperation among the members of a regional bloc that goes well beyond liberalizing intraregional trade or the introduction of a common external tariff; it must also ensure a fair distribution of the gains from integration so that each member can reap net benefits from participation.

The reasons for inequalities in the distribution of gains stem from structural factors, but also, in many cases, from economic policies. In a customs union or a common market, the structure of the common external tariff and local content rules are not neutral in the sense that they may serve the interests of some members better than others. Moreover, the members of a regional agreement frequently pursue their own industrial policies – either in accord with their partners or unilaterally. Thus there is the risk that the lack of a coordinated industrial policy could lead to “beggar-thy-neighbour” behaviour,

eventually weakening the integration process. In fact, not all the members of a trading bloc have the same financial and institutional capacities to promote production and exports. The EU dealt with that problem by harmonizing national support policies and by transferring some areas of national policy-making to the regional level so as to enable a better distribution of the gains from integration. In cooperation agreements among developing blocs, this is largely a pending issue, although it is receiving increasing attention.

Regional monetary and financial cooperation

Since the 1990s there has been greater interest in financial and monetary cooperation among developing countries, not least because the development prospects of many countries have been shaped more by the globalization of finance than by global trade expansion. Financial crises in emerging market economies illustrated the risks stemming from the volatility of private international capital flows, especially speculative short-term flows, and the detrimental effects that the vagaries of international financial markets could have on international trade and sustained growth. They showed once again that financial crises are rarely limited to a single country; investor behaviour can easily infect other countries, even if they have good economic fundamentals.

Regional monetary and financial cooperation can take various forms and rely on different instruments. The initial steps may aim at providing long-term financing to participating countries through regional development banks and the creation of regional capital markets. More sophisticated forms of cooperation involve the use of regional clearing banks to facilitate intraregional trade payments and short-term financing for countries facing balance-of-payments problems. Bond issuance in regional currencies and loans in local currencies may help to reduce a currency mismatch and induce the development of regional financial markets.

Further steps towards closer regional cooperation in the field of finance include the creation of regional exchange-rate mechanisms and monetary unions. Regional arrangement for exchange-rate management among countries with a relatively high and increasing share of intraregional trade and financial cooperation can be an important element in the process of creating a common market, as volatility of exchange rates may distort trade flows and undermine trade integration. Even if such arrangements require greater macroeconomic coordination among the participating countries, they can be useful for countries with very open economies targeting stability of the internal and the external value of their currency. Experiences in some regions show that the often severe effects of volatile short-term capital flows, arbitrage and frequent over- and undervaluations, particularly on growth and investment, can be considerably reduced.

Monetary and exchange-rate policy has been by far the most developed area of regional cooperation and integration in Africa. With two currency unions and nominal exchange-rate stabilization in the South African Common Monetary Area (CMA), Africa has taken the lead in the developing world in regional monetary integration. Exchange-rate pegs and the associated greater credibility of their monetary policy have helped a number of countries to achieve convergence in their price levels, though with mixed results due to different exchange-rate regimes. The greatest handicap of exchange-rate based stabilization has been the risk of an appreciation of the real exchange rate due to positive inflation differentials between the domestic and anchor currencies.

The European experience with different forms of monetary cooperation, which eventually led to a fully-fledged monetary union, offers important lessons for developing countries. It shows that there is no viable alternative to managing some form of fixed or floating exchange rates if adverse implications for trade and the smooth functioning of a common market are to be avoided. Additionally, it implies that regional cooperation in monetary affairs and the design of monetary cooperation in a manner that aims at full monetary union as the final target are superior to systems based on currency anchoring.

However, the failure of European integration to produce an economic performance comparable to that of the United States since the end of the Bretton Woods system shows that for development efforts at the national level to succeed, the formulation and effective implementation of a national development strategy and appropriate macroeconomic policies are of major importance. In this respect, Europe's orthodox approach towards macroeconomic policies holds important lessons for developing countries. The most successful cases of economic catch-up, namely those in Asia, consistently rejected the simple concept of using monetary policy to achieve price stabilization. Indeed, the assignment of policies to reach this target was just the opposite of the orthodox approach. In the Asian model of stabilization, monetary policy sought to stimulate investment and growth whereas heterodox tools were used to control inflation. Income policies or direct government intervention in the goods and labour markets were the preferred instruments to stabilize prices. Clearly, in an environment of extremely rapid growth with its notorious risk of creating an overheated economy, this approach has passed the acid test.

Basic elements of development-oriented regional cooperation

Regional cooperation in its simplest form may focus on lowering technical and bureaucratic barriers to trade by means of coordinated administrative reforms and the dissemination of critical information on trading possibilities through trade fairs and the promotion of regional business contacts. Putting in place or upgrading physical infrastructure for transport and communications is a more serious challenge that requires a more advanced form of cooperation and coordinated financial efforts. Cooperation might thereafter progress to the pooling of regional resources in order to meet common challenges, such as accelerating diversification of production in dynamic sectors, upgrading the industrial structure and raising agricultural productivity. Regional cooperation may also be a means of dealing with global public goods, such as knowledge generation and addressing environmental problems.

In some areas, such as trade and transport facilitation, and energy and water supply, regional cooperation is indispensable for most countries in order to identify and overcome bottlenecks that extend beyond national boundaries and for the formulation of proposals that require parallel undertakings in several countries. Improving trade logistics and transport connectivity is an important element of any policy that seeks to improve trade opportunities in order to accelerate growth and structural change. In many cases, formal trade liberalization is not as successful as it might be because some fundamental aspects of trade logistics, such as facilitation of customs formalities, harmonization of procedures and standards are neglected, or are used as non-tariff trade barriers. In other cases, poor infrastructure, or its complete absence, makes trade physically difficult, if not impossible, quite independently of the trade regime. The existence of tariff barriers or quantitative constraints pose formidable obstacles to trade, but they do not render trade exchanges completely impossible, as does the absence of an

appropriate regional infrastructure. Therefore, rather than focusing exclusively on the legal aspects of trade policies in regional cooperation, additional efforts to tackle these other aspects of intraregional economic relations may be as important as, if not more than, further trade liberalization.

Trade logistics are critical

Today, high transport costs and poor connectivity are more detrimental to a country's development than ever before; they pose a particular challenge for landlocked developing countries. Many countries, especially in Africa, are still better connected to industrialized countries in other continents through air and maritime transport services than they are to neighbouring countries. Thus their trade is not hindered by distance alone, but also by high transport costs and poor connectivity. These obstacles can be overcome through regional partnerships in trade and transport facilitation, with a view to improving transport infrastructure, transit arrangements and trade facilitation at border crossings.

Trade within a geographical region is often land-based, whereas long-distance trade is mostly seaborne or airborne. For a trade facilitation programme to be coherent with a country's broader trade and development strategy, it is therefore necessary first to decide with which country or region trade should be facilitated as a priority. Enhancing trade with partners outside the region would require an emphasis on measures such as pre-arrival customs clearance at seaports, or the use of port community portal systems or standardized formalities of the International Maritime Organization. If regional integration is the priority, the emphasis would be on measures such as joint border operations, mutual recognition of trade- and transport-related documents and licences within a region, or common documents, and customs automation at border crossings.

Cooperation with neighbouring countries is indispensable, in particular, for landlocked developing countries to become "land-linked". Indeed, such cooperation can serve the mutual interests of landlocked developing countries and coastal transit countries to a much greater extent than is often assumed. It could set in motion a regional dynamic through a virtuous circle of better and less expensive transport infrastructure and market information systems that allows more trade to take place, which in turn may result in economies of scale and greater competition in transport as well as more favourable financial conditions for further improvements of the infrastructure.

Benefits of large, energy-related regional infrastructure projects

Faster growth and expansion of industry in low- and middle-income countries has increased their energy needs. An efficient energy infrastructure is a precondition for economic development in general, and for industrial development and diversification in particular. Yet it is very capital-intensive and often requires large-scale investment, which many developing-country governments find difficult to finance. Mobilizing such financing through privatization may not always be compatible with long-term strategic considerations. Moreover, energy supply and distribution is largely determined by the natural endowments of each country, and only a few countries can meet their energy needs without cooperation with neighbouring countries. The particular structural characteristics of this sector make it prone to market failures, which because of its importance for the functioning and expansion of almost all other sectors, risk being amplified. For all these reasons, regional cooperation in the energy sector can be a starting point for eventual cooperation in other and more far-reaching areas of policy coordination or common policy-making, as shown by the European example. When undertaken among poorer countries, initiatives for regional cooperation in the areas of energy supply and distribution and transport infrastructure, may also serve to leverage external financial support.

Energy and water supply and distribution have been areas of bilateral and regional cooperation in various developing regions, and there appears to be considerable scope for efficiency and security gains from strengthening such cooperation. After disappointing results with a market-based approach in line with wide-ranging policy reforms in the 1980s and 1990s, there has recently been a revival of regional energy cooperation among governments, in particular in Latin America. The perception that both the State and regional cooperation have an important role to play in the energy sector is not new: it was the basis for regional institution-building in post-war Western Europe, even before the creation of the European Economic Community and the European Free Trade Association.

Energy policy in the new millennium should not only ensure that traditional energy supplies match increasing demand; it also needs to focus on innovative measures to increase energy efficiency and support the exploration and use of alternative sources of energy. The challenges in this regard are formidable: the costs of research and technological innovation are high, the adjustment process will be long and uneven, and the potential energy sources are not equally distributed across countries. The importance of these factors grows as industrial development and output growth progress and environmental concerns become more and more acute.

Thus, strengthening forward-looking regional cooperation in the area of energy has the potential to support national policy efforts aimed at accelerating the development of manufacturing industries in developing countries. This new orientation is reflected in the ASEAN 2020 Vision, which recognizes that a greater focus on regional cooperation in energy efficiency and conservation, and on the development of new and renewable energy resources in order to strengthen regional energy security may soon become a determining factor for long-term growth. But translating this intention into concrete action will require supporting policies and financial commitments.

Industrial policy as a regional endeavour

Regional coordination of major investment projects to avoid costly overcapacities in very capital-intensive industries can be an important motivation not only for regional cooperation in the energy sector, but also for industrial policy more generally. Such cooperation is not always easy to achieve because it is often perceived as undermining national interests, especially when it involves financial transfers to a supranational institution. However, the long-term benefits can often outweigh such financial costs, in particular when viewed in terms of its potential, following an initial confidence-building phase, for extending into areas where national capacities are limited. In this regard, the experience of Western Europe, beginning with the European Coal and Steel Community in the early 1950s, contains useful lessons, even though the circumstances differed considerably from those prevailing in today's developing regions.

The growth process is often associated with technological development. Most developing countries rely heavily on accessing technology from abroad for application in local production systems. This requires appropriate national policies and institutions. National innovation systems with an explicit regional dimension could be devised for collaborative research, training schemes and information gathering. These may involve complex institutional issues such as the design of intellectual property regimes, and they may be better supported by the harmonization of rules and laws on a regional basis and by pooling resources to ensure their more effective management in the context of local needs and conditions. Tight budgets and human resource constraints prevent many developing-country governments from offering greater support to "horizontal" industrial policies, for example through more funding for innovation and research and development activities. Often such activities, that generally lack a strong domestic lobby, have relatively long gestation periods and require substantial investments in physical and human capital. Costs of further developing already advanced technologies and adapting them to local conditions can be borne more easily when financed by several governments through a regional cooperation agreement or by regional development banks.

Industrial policy instruments aimed at boosting capital accumulation in manufacturing may vary, depending on whether they are national or regional. While tax incentives are probably more effectively applied at the national level, financing of such investment may well be supported through regional initiatives such as regional development banks or the development of regional financial markets, especially where national financial markets may be too small and the international financial markets inaccessible for various reasons.

Regional cooperation in energy and industrial policy is of course a complement to, not a substitute for, pursuing national strategies, but its scope can extend beyond simple consultation and coordination. It may also involve the financing and implementation of projects that would not be feasible for an individual developing country alone. At the very least, successful cooperation in all these areas is likely to have the indirect effect of confidence-building, thus preparing the ground for more far-reaching forms of regional cooperation.

The way forward

It must be recognized that there are limits to the developmental effects of regional integration arrangements among developing countries, depending on the level of development of the members. Those countries and regions that lack a sizeable capital goods sector have to earn the necessary foreign exchange to enable them to import capital and intermediate goods from the developed or more industrially advanced developing countries. Similarly, those low-income countries whose exports are highly concentrated in a small number of primary commodities will generally find limited markets in their own region and in other developing countries. For both reasons, developing countries that are still dependent on primary production or are at an early stage of industrial development can benefit less from regional integration with partners at similar stages of development than those with a more diversified production structure.

Experience over the past 50 years has shown that regional cooperation is neither a necessary nor a sufficient condition for developing strong regional dynamics, but it can help to strengthen national policies and regional integration dynamics resulting from the interaction of private firms. If it is well conceived and responds to the need to overcome region-specific constraints and gaps created by existing global governance structures, there is considerable potential for real benefits from closer regional economic integration. Such integration does not result automatically from trade liberalization. Whatever the potential benefits of trade liberalization at the regional or global levels in terms of accelerating growth and structural change in developing countries, governments may be well advised to explore carefully the policy options available to them in order to maximize the gains from greater trading opportunities both within their region and with other regions. This is particularly important today, as increased integration into the world economy and multilateral commitments are limiting the national policy space and the possibilities for using traditional instruments of trade policy.

Strengthened regional cooperation does not preclude other forms of international or South-South cooperation. While proximity matters for some areas of cooperation, it may be irrelevant for others. An example of the need for South-South cooperation, where proximity does not necessarily matter, is in the coordination of incentives to attract FDI, especially in the primary sector, where countries in different regions but with similar natural resource endowments frequently “compete” for external capital. On the other hand, regional cooperation is more important for coordinating policies for attracting FDI to the manufacturing or service sectors, where there is a greater likelihood for competing interests among countries in the same region to lead to a race to the bottom in offering incentives to potential foreign investors. Regional cooperation in this area would be easier if other elements of cooperation were already in place. Indeed, in some cases it is precisely because certain institutional arrangements for cooperation and coordination already exist that regional cooperation in other areas becomes possible.



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Secretary-General of UNCTAD

CURRENT ISSUES IN THE WORLD ECONOMY

A. Recent trends in the world economy

1. Global growth

The world economy is expanding vigorously for the fifth year in a row. Global gross domestic product (GDP) is set to grow at 3.4 per cent in 2007, measured at market exchange rates,¹ compared to 4 per cent in 2006. As most of this moderate slowdown can be explained by a slowdown in the United States economy, GDP growth rates in other regions – including developing and transition economies – should remain more or less the same as in 2006 (table 1.1).

Deceleration of growth in the United States was due mainly to a reversal in the previously booming housing market, which had sustained private consumption. Given the higher long-term interest rates, there is a possibility of an outright contraction in house prices that might further erode the solvency of private households and precipitate a reduction in private consumption. Similar concerns hold for the United Kingdom, where an increasingly restrictive monetary policy and growing private indebtedness threaten to reduce domestic consumption, which had underpinned

growth in recent years. In Germany and Japan, where the acceleration of growth had been stimulated mainly by rapidly rising net exports and a recovery in fixed investment, private domestic demand remains fragile, despite rising employment and some success in reducing unemployment.

East and South Asia continue to experience particularly high growth, owing to the strong performances of China and India. Their high investment ratios (exceeding 40 per cent of GDP in China, and close to 30 per cent in India) can only persist if large external shocks can be avoided and if economic policy is not forced to limit expansion to a greater extent than currently envisaged. This should not lead to an overshooting of exchange rates and to a major policy shift in the United States. Other countries in East, South and South-East Asia have benefited from the dynamism of India and China through strong export performances.

The pace of economic expansion has also been rapid in other developing regions and in the transition economies, including the Commonwealth of Independent States (CIS), which have benefited from strong demand for primary com-

Table 1.1

WORLD OUTPUT GROWTH, 1991–2007^a								
<i>(Annual percentage change)</i>								
<i>Region/country</i>	<i>1991–2000^b</i>	<i>2001</i>	<i>2002</i>	<i>2003</i>	<i>2004</i>	<i>2005</i>	<i>2006^c</i>	<i>2007^d</i>
World	2.9	1.5	1.8	2.6	4.1	3.4	4.0	3.4
Developed countries	2.5	1.1	1.2	1.8	3.1	2.4	3.0	2.4
<i>of which:</i>								
Japan	1.1	0.2	0.3	1.4	2.7	1.9	2.2	2.3
United States	3.5	0.8	1.6	2.5	3.9	3.2	3.3	2.0
European Union	2.2	1.9	1.2	1.2	2.3	1.7	3.0	2.8
<i>of which:</i>								
Euro area	2.1	1.9	0.9	0.8	2.0	1.3	2.8	2.6
France	2.0	1.9	1.0	1.1	2.3	1.2	2.2	2.0
Germany	1.8	1.2	-0.0	-0.2	1.3	0.9	2.8	2.8
Italy	1.5	1.8	0.3	0.0	1.1	-0.0	1.9	1.9
United Kingdom	2.7	2.4	2.1	2.7	3.3	1.9	2.8	2.7
South-East Europe and CIS	-4.2	5.9	5.2	7.1	7.7	6.4	7.5	7.0
South-East Europe ^e	-0.9	4.8	4.7	4.3	6.2	4.7	6.2	5.6
CIS	-5.0	6.2	5.4	7.8	8.1	6.8	7.7	7.3
<i>of which:</i>								
Russian Federation	-4.7	5.1	4.7	7.3	7.2	6.4	6.7	6.4
Developing countries	5.0	2.6	3.8	5.1	7.1	6.5	6.9	6.4
Africa	2.7	3.7	3.4	4.9	5.3	5.3	5.6	6.0
North Africa (excl. Sudan)	3.2	3.9	3.4	5.3	5.0	4.5	5.7	5.9
Sub-Saharan Africa (excl. South Africa)	2.6	4.1	3.4	5.5	5.8	6.2	5.8	6.8
South Africa	2.1	2.7	3.6	3.1	4.8	5.1	5.0	4.8
Latin America and the Caribbean	3.2	0.3	-0.5	2.1	6.2	4.8	5.7	4.7
Caribbean	1.8	0.5	2.5	2.7	3.7	6.9	8.5	6.2
Central America (excl. Mexico)	4.5	1.7	2.4	3.6	4.0	4.5	6.0	4.6
Mexico	3.1	-0.0	0.8	1.4	4.2	3.0	4.8	2.5
South America	3.3	0.3	-1.5	2.4	7.4	5.4	5.8	5.5
<i>of which:</i>								
Brazil	2.9	1.3	2.7	1.1	5.7	2.9	3.7	4.5
Asia	6.5	3.5	5.9	6.5	7.8	7.4	7.6	7.2
East Asia	8.5	5.0	7.3	6.9	8.2	7.8	8.4	8.0
<i>of which:</i>								
China	12.4	8.3	9.1	10.0	10.1	10.2	10.7	10.5
South Asia	5.3	4.4	4.7	7.0	7.7	8.0	7.9	7.5
<i>of which:</i>								
India	6.0	5.0	4.0	7.1	8.5	9.2	9.2	8.5
South-East Asia	5.1	2.1	4.8	5.4	6.6	5.7	6.0	5.7
West Asia	3.9	-0.9	3.5	5.4	7.8	6.9	5.5	5.2

Source: UNCTAD secretariat calculations, based on *UNCTAD Handbook of Statistics* database; and United Nations, Department of Economic and Social Affairs (UN/DESA), *LINK Global Economic Outlook 2007* (May 2007).

a Calculations are based on GDP at constant 2000 dollars.

b Average.

c Preliminary estimates.

d Forecast.

e Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania, Serbia and Montenegro, and the former Yugoslav Republic of Macedonia.

modities and, in most cases, from considerable improvements in their terms of trade. In several countries, higher prices for energy and other primary commodities have generated huge surpluses in the current account, which have contributed to higher revenue for domestic agents, including governments. This has paved the way for an expansion in private consumption and a strong recovery in investment. Even in countries that have not benefited much from improvements in their term of trade, such as Brazil and South Africa, governments have launched proactive pro-development programmes that seek to sustain growth rates through increased investment in infrastructure.

To a certain extent this is also true for Africa as a whole. That region is set to grow at 6 per cent in 2007, mainly driven by producers of oil and other commodities that are in strong demand on the global market. Latin America is expected to see a growth rate of slightly below 5 per cent, whereas West Asia is likely to complete a five-year period of growth rates above 5 per cent, mainly as a result of huge terms-of-trade gains in the oil-exporting countries of the region.

The main risks for continued global economic expansion come from the failure to address the current global imbalances (discussed in section B below). If the present slowdown in the United States economy deepens and it slips into a recession, and if the main surplus countries, despite an appreciation of their currencies, do not initiate much greater expansionary policies based on domestic demand, rather than on net exports, the outlook will be rather bleak. With respect to stimulating demand, some positive developments are under way. In China, economic policy is seeking to invigorate domestic consumption by increasing the incomes of low-wage earners (including farmers' disposable incomes) and by improving the social security system. It is also attempting to slow down investment and some exports, especially those from highly polluting and energy-consuming industries, through taxation and monetary policy (Tao, 2007). Among the high-surplus developed countries, expenditure switching is envisaged in Germany with the appreciation of the euro. In Japan domestic consumption is picking up following several years of sluggishness, but due to speculative capital flows the yen is extremely weak and is further fuelling exports. It is not cer-

Table 1.2

PER CAPITA GDP GROWTH BY REGION AND ECONOMIC GROUPING, 1981–2007

(Per cent)

	Average annual growth			Overall growth
	1981–1989	1990–2002	2003–2007	1981–2007
World	1.4	1.2	2.3	41.4
Developed economies	2.5	1.8	2.0	67.5
Economies in transition	1.9	-4.0	7.3	-25.8
Developing economies	1.7	3.0	5.0	112.5
<i>of which:</i>				
Africa	-0.5	0.3	3.0	16.4
America	-0.3	1.1	3.5	22.7
West Asia	-1.7	1.1	4.1	16.0
East and South Asia	5.1	5.3	6.3	317.5

Source: UNCTAD secretariat calculations, based on *UNCTAD Handbook of Statistics*; and table 1.1.

tain whether the effects of these developments will be strong enough to avoid a recession in the process of redressing the imbalances.

From a medium-term perspective, the recent economic performance of developing and transition economies shows a notable improvement in their catch-up efforts with developed countries, although in absolute terms the differences in per capita income among them are growing. For more than two decades, between 1981 and 2002, the average growth rate of developed countries was higher than that of most developing economies, while the per capita GDP of transition economies plummeted between 1990 and 2002 (table 1.2). During this period, the only developing region that reduced its relative gap (in terms of real per capita GDP) with the developed countries was East and South Asia. Overall per capita GDP growth in Africa and West Asia over the period 1981–2007 has increased by 16 per cent; and in Latin America it has increased by 23 per cent. Since 2003, Africa, West Asia and Latin America have achieved high and stable growth rates, after more than two decades of stagnation. The already rapid growth

rate in East and South Asia has accelerated to reach a phenomenal overall growth of more than 300 per cent since 1980 – effectively doubling its GDP per capita in only 14 years. The transition economies resumed growth in 1999; since 2000, they have been the most rapidly growing economies in the world, with a cumulative increase of 73 per cent in real per capita GDP; however, this recovery has occurred after such a deep depression that, at present, their average per capita GDP is still below the level of 1980.

In relative terms, in the last 27 years there has been only a moderate reduction in the gap between developing and developed countries: in 1980, the real per capita GDP of developed countries was 23 times higher than that of developing countries, but it narrowed to 18 times in 2007. The performance of East and South Asia was almost exclusively responsible for this overall reduction in global inequality, given that their gap with developed countries was reduced, from 48 times in 1980 to 19 times in 2007. For Africa, Latin America and the transition economies, the relative gap is much wider today than in 1980, despite improvement in the last five years.

Strong GDP growth over the past few years has led to a significant increase in employment. However, unemployment rates fell significantly only in Latin America and the transition economies, although at 8 and 9 per cent, respectively, they remained at relatively high levels. In Asia, where official unemployment is quite different from region to region, the rates have remained fairly stable over the last five years: at 3.5–4 per cent in East Asia, around 5 per cent in South Asia and close to 6.5 per cent in South-East Asia. Growth rates in South-East Asia have not been able to lower unemployment to levels that existed before the 1997–1998 financial crisis. In sub-Saharan Africa, there has been only a minor fall in unemployment (UNCTAD, 2007a: chart 7). The slow response of unemployment to growth in developing regions may be due to the huge reserves of labour that are stimulated to enter the formal markets only in phases of sustained demand for labour and rising wages.

Investment has also responded positively to the improved economic environment since the turn of the century. While real investment in the de-

veloped countries has remained rather flat (and investment/GDP ratios have declined), it has increased significantly in developing and transition economies since their recovery from the financial crises. As real investment growth generally outpaced that of real GDP, the investment ratio rose in most developing and transition economies. The partial exception to this trend is that of South-East Asia, where GDP/investment ratios have improved since 1998, but not to their very high pre-crisis levels. This improvement in investment rates has occurred at a time when many developing countries have posted significant current-account surpluses, turning them into net exporters of capital. The fact that the export of capital by poor developing countries (supposedly endowed with little capital) to the rich North (supposedly endowed with abundant capital) has not constrained their ability to invest larger sums in fixed capital at home, challenges fundamental orthodox development theory. This implies a need for rethinking the most crucial assumptions about the functional relationship between savings, investment, capital flows and the different policies and paths for catching up (UNCTAD, 2007a: 11).

2. Trade, commodity prices and terms of trade

(a) Expansion of world trade

In parallel with the strong performance of the world economy, world trade expanded vigorously in 2006. Total merchandise exports grew by almost 15 per cent in current dollar prices, with an increase in volume terms of 8 per cent (table 1.3) and in unit value terms of almost 6.5 per cent. Much of the increase in dollar unit values is related to rising commodity prices (discussed below).

In 2006, export expansion (by volume) was evenly distributed among developed and developing countries, although with wide divergences between developing regions. Developed countries benefited from increasing demand from commodity exporting countries as a result of their higher export revenues. The European Union (EU) benefited particularly from increasing sales to oil-exporting

Table 1.3

	Export volume						Import volume					
	2001	2002	2003	2004	2005	2006	2001	2002	2003	2004	2005	2006
	World	-1	5	6	11	5	8	-1	5	7	12	6	7
Developed economies	-1	3	3	9	5	9	-1	3	5	9	6	6
<i>of which:</i>												
Japan	-8	8	9	13	5	9	1	1	6	6	2	2
United States	-6	-4	3	9	7	10	-3	4	5	11	6	6
European Union	1	4	3	9	5	9	1	3	5	9	6	7
South-East Europe and CIS	5	10	10	13	0	6	17	14	22	20	12	12
South-East Europe	10	15	22	22	6	10	17	17	26	20	7	13
CIS	5	9	8	11	-1	6	17	12	21	20	14	11
Developing economies	-1	9	12	17	6	9	-1	7	12	19	7	10
Africa	1	5	4	9	1	1	7	7	7	14	10	5
Latin America and the Caribbean	2	0	4	9	5	4	0	-7	1	14	8	12
East Asia	-1	15	21	24	17	18	-1	14	19	19	6	10
<i>of which:</i>												
China	8	24	34	32	26	25	13	23	34	25	8	13
South Asia	0	15	10	12	11	8	7	13	13	16	13	6
<i>of which:</i>												
India	5	17	13	19	15	14	4	11	18	19	19	9
South-East Asia	-5	7	7	17	6	11	-7	7	8	18	5	6
West Asia	-3	5	6	17	-1	2	-2	6	9	37	10	15

Source: UNCTAD secretariat calculations, based on UNCTAD Handbook of Statistics database.

countries in West Asia and the CIS; and countries exporting capital goods also profited from expanding investment in other developing regions. The United States also registered strong export growth, of 10 per cent – its highest since the beginning of the 2000s – as a result of higher demand from the recovering economies of the EU and Japan and a depreciating dollar. In Japan, rapid export growth was mainly due to the weak yen and to increased demand for Japanese products from China and other South-East Asian countries. In developed countries, imports (by volume) grew at a slower pace than exports reflecting the deterioration (albeit quite moderate) in their terms of trade.

Output growth in developing and transition countries has been stimulated by the surge in ex-

port revenues. In some regions, the purchasing power of exports increased through the expansion of the volume of goods exported; in others, gains from changes in the terms-of-trade played a greater role. Exporters of manufactures from East, South and South-East Asia belong to the first group. China and India, in particular, contributed significantly to regional trade expansion. Export-led growth in China led to a 25 per cent increase in its exports (by volume), which continued to outpace global trade growth by far. India's export growth (by volume) was also higher than the world average, at 14 per cent, with a surge in manufactured exports. The export growth performance of other countries in East and South Asia was also good as a result not only of healthy global demand, but also of a high level of intraregional trade

in manufactures. In these countries, export growth (by volume) continued to significantly exceed import growth. Greater integration with the EU is also the reason for increasing trade volumes in South-East Europe. Import growth (by volume) was higher than export growth both in South-East Europe and the CIS, as a result of sustained economic growth.

Export performance (in volume terms) was less buoyant in Africa, Latin America and the Caribbean and West Asia. The rapid expansion of 2004 in the volume of oil exports from the Gulf countries could not be sustained in 2005 and 2006, as most of the spare production capacity had already gone on-stream. Export volumes were relatively stable in Africa and West Asia, and increased by 4 per cent in Latin America and the Caribbean. However, given the large weight of primary commodity exports in total exports in these regions, high commodity prices boosted growth in export value: by 15 per cent in Africa, 18 per cent in West Asia and 20 per cent in Latin America and the Caribbean. As a result of this improvement in the terms of trade and their strong economic growth, import demand has also been growing fast in these regions.

Exports of developing countries in value terms have consistently been growing faster than those of developed countries in the 2000s. As a result, the share of developing countries in global exports increased from 32 per cent in 2000 to 37 per cent in 2006. However, most of this increase was in Asia; China alone accounted for much of it, as its share in global exports increased from 3.9 per cent to 8.1 per cent over this period. Africa's share in total exports (by value) increased only slightly, from 2.3 to 2.8 per cent, and that of Latin America and the Caribbean remained roughly stable – just below 6 per cent. The share of South-East Europe and the CIS also increased, from 2.6 in 2000 to 4.1 per cent in 2006. By contrast, the share of developed countries fell from 65.6 to 59.1 per cent during that period.

Future developments in world trade and in the performance of the global economy will be influenced to a large extent by the Doha Round of multilateral trade negotiations under the aegis of the World Trade Organization (WTO). These negotiations, which were resumed in February 2007

following their suspension in July 2006, will require strong efforts and political will to advance and to achieve a truly development-oriented outcome. The negotiating parties should recognize the structural differences between industrialized and developing countries and the resulting need of developing countries to use policy instruments that could help maximize the impact of trade integration on the development of their domestic productive capacities.

(b) Commodity price developments

In 2006 and early 2007 commodity producers continued to benefit from the boom in commodity markets which had started in 2002. Indeed, the growth in non-fuel commodity prices strengthened in 2006, at a rate of 30.4 per cent – the highest since the start of the upswing (table 1.4). Price hikes continued for almost all commodities in 2006, although the rate of increase varied by commodity and commodity group. The minerals, ores and metals group remained in the lead with the most pronounced rise (60.3 per cent in 2006); food commodities and agricultural raw materials also saw sharp increases, the lowest increases being in the tropical beverages and vegetable oilseeds and oils groups. Prices for tropical beverages increased significantly less in 2006 than in 2005, although their markets, mainly for coffee, seem to have recovered from the crisis and oversupply situation of the late 1990s and early 2000s. Furthermore, the growth rate in the price of crude petroleum, of 20.4 per cent in 2006, was less than half that of 2005.

As a result, the UNCTAD price index for non-fuel commodities reached its highest level in current dollars since 1960. Price indices of minerals, ores and metals, agricultural raw materials and crude petroleum also hit an all-time record in nominal terms. The food index reached its highest level since its last peak in 1996, while the price indices for tropical beverages and vegetable oilseeds and oils remained below their previous peaks attained in 1997 and 1998 respectively. The prices of agricultural raw materials equalled those reached in 1995. However, even though the price indices of all commodity groups in nominal terms have been above their declining long-term trend in real terms, most real prices of commodities are still far below

Table 1.4

WORLD PRIMARY COMMODITY PRICES, 2001–2006							
<i>(Percentage change over previous year)</i>							
<i>Commodity group</i>	<i>2001</i>	<i>2002</i>	<i>2003</i>	<i>2004</i>	<i>2005</i>	<i>2006</i>	<i>2002–2006^a</i>
All commodities (in current \$)^b	-3.6	0.8	8.1	19.4	12.2	30.4	88.8
All commodities (in SDRs)^b	0.2	-0.8	-0.2	13.1	12.5	30.7	66.0
Food and tropical beverages	0.4	0.4	2.3	13.2	8.8	17.8	48.4
<i>Tropical beverages</i>	-20.6	11.7	6.2	6.4	25.5	6.7	51.3
Coffee	-29.0	4.7	8.7	19.8	43.8	7.1	100.6
Cocoa	22.7	63.3	-1.3	-11.8	-0.7	3.5	-10.4
Tea	-20.2	-9.5	8.4	2.1	9.1	11.7	34.9
<i>Food</i>	2.8	-0.5	1.9	13.9	7.2	19.0	48.0
Sugar	5.6	-20.3	2.9	1.1	37.9	49.4	114.5
Beef	10.0	-0.3	0.4	17.8	4.1	-2.4	20.3
Maize	1.1	10.4	6.5	5.0	-12.0	24.4	22.5
Wheat	9.0	16.6	-0.7	6.8	-1.4	26.6	32.3
Rice	-15.3	11.0	4.1	23.1	17.1	5.5	58.3
Bananas	38.8	-9.6	-28.7	39.9	9.9	18.5	29.8
Vegetable oilseeds and oils	-6.4	24.9	17.4	13.2	-9.5	5.0	26.4
Soybeans	-7.5	8.6	24.1	16.1	-10.4	-2.2	26.3
Agricultural raw materials	-3.9	-2.4	19.8	9.9	7.2	15.0	62.3
Hides and skins	5.5	-2.9	-16.8	-1.7	-2.1	5.1	-15.9
Cotton	-19.0	-3.6	37.2	-3.3	-11.6	5.9	24.2
Tobacco	0.0	-8.2	-3.5	3.6	1.8	6.4	8.2
Rubber	-14.1	33.1	41.7	20.3	15.2	40.4	175.7
Tropical logs	6.4	-10.5	20.1	19.2	0.3	-4.7	36.9
Minerals, ores and metals	-10.8	-2.7	12.4	40.7	26.2	60.3	219.9
Aluminium	-6.8	-6.5	6.0	19.8	10.6	35.4	90.4
Phosphate rock	-4.6	-3.3	-5.9	7.8	2.5	5.3	9.5
Iron ore	4.5	-1.1	8.5	17.4	71.5	19.0	160.0
Tin	-17.5	-9.4	20.6	73.8	-13.2	18.9	116.2
Copper	-13.0	-1.2	14.1	61.0	28.4	82.7	331.1
Nickel	-31.2	14.0	42.2	43.6	6.6	64.5	257.9
Tungsten ore	45.5	-41.8	18.0	22.9	120.7	36.2	336.2
Lead	4.9	-4.9	13.8	72.0	10.2	32.0	184.6
Zinc	-21.0	-12.1	5.1	29.1	27.9	136.7	311.1
Gold	-2.9	14.4	17.3	12.6	8.7	35.9	95.0
Crude petroleum	-13.3	2.0	15.8	30.7	41.3	20.4	157.6
Memo item:							
Manufactures^c	-2.1	0.7	9.2	8.3	2.5	3.3	25.3

Source: UNCTAD secretariat calculations, based on UNCTAD, *Commodity Price Bulletin*, various issues; and United Nations Statistics Division (UNSD), *Monthly Bulletin of Statistics*, various issues.

Note: In current dollars unless otherwise specified.

a Percentage change between 2002 and 2006.

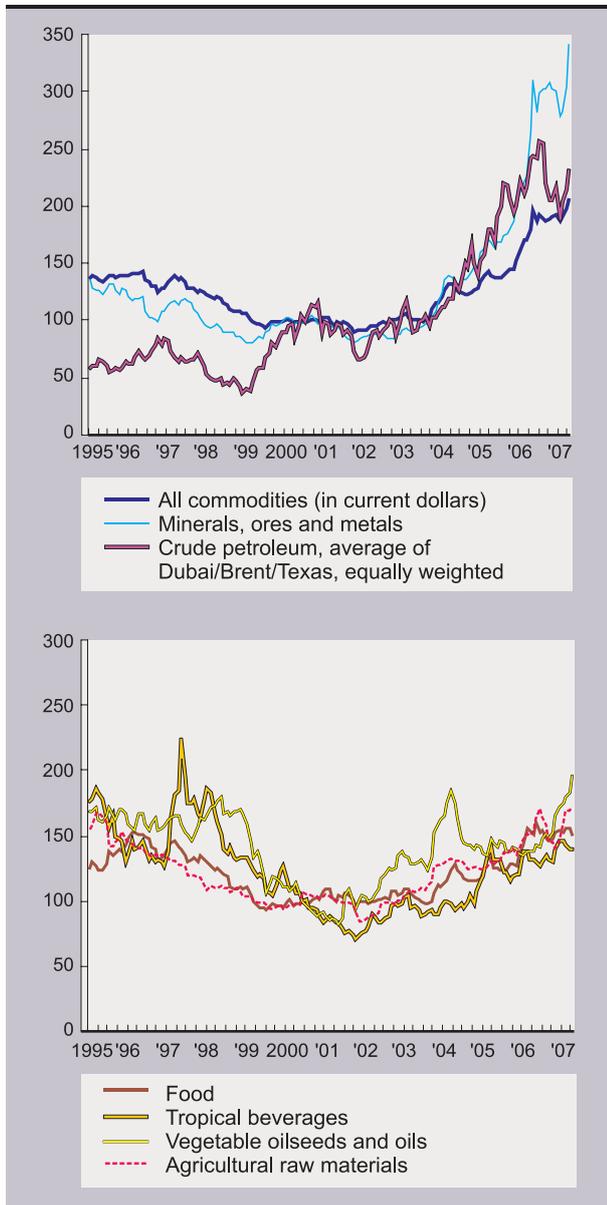
b Excluding crude petroleum.

c Export unit value of manufactured goods of developed countries.

Figure 1.1

MONTHLY COMMODITY PRICE INDICES BY COMMODITY GROUP, JAN. 1995–APRIL 2007

(Index numbers, 2000 = 100)



Source: UNCTAD, *Commodity Price Bulletin*, various issues.

their levels of the 1970s and early 1980s. Only the real price for the minerals, ores and metals group has substantially exceeded those levels.

While on average, commodity price indices in 2006 were much higher than those in 2005, a

closer analysis of their short-term evolution reveals a volatile pattern throughout the year, with a slowdown, or even a decline in some cases, in the second half of the year and the beginning of 2007 (fig. 1.1). This is related to expectations of slower global economic growth, increased supplies of some commodities, some substitution effects in minerals and metals and energy commodities, a correction in financial markets as a result of the changing behaviour of financial investors in relation to commodities, as well as the strong influence of crude petroleum prices on the prices of many other commodities. According to some analysts, there are indications that commodity prices may have peaked in most cases, which would signify an end to the commodity price boom (Suni, 2007). However, this is still uncertain, as commodity prices have continued to rise since February 2007.

The driving forces behind the commodity price rally in 2006 essentially remained the same as in the previous years of rising prices, although with varying intensity for different commodities. The market fundamentals remained generally tight as a result of strong demand growth and a slow supply response. This resulted in low inventories, particularly for minerals and metals, but also for grains. Apart from the physical market factors, financial investment in commodities was also high in 2006.

The strong demand for commodities stemmed mainly from robust global economic growth, and especially from growth in the United States and the rapidly expanding developing economies, such as China and India. China continued to grow at two-digit rates in 2006 (table 1.1): its industrial production increased by 12.5 per cent (National Bureau of Statistics of China, 2007) and the share of fixed investment in GDP remained above 40 per cent. The dynamic pattern of growth, industrialization and urbanization in China is highly intensive in commodity use. This is leading to increasing South-South trade as China's imports from commodity-exporting developing countries rise. China has also increased its outward FDI in natural resources in developing countries (*World Investment Reports (WIR) 2006 and 2007*). So far, the surge in Chinese demand for commodities has had the greatest impact on the prices of metals and minerals, agricultural raw materials and some food commodities, such as soybeans. The higher prices of other

food products in 2006 may also be partly related to growing demand in China due to gradually changing dietary habits as standards of living improve (*TDR 2005*, chap. II). However, the major factor in the current rise in demand for agricultural commodities, particularly maize and sugar, is the expansion in demand for biofuels, which is closely linked to developments in energy prices.

Supply constraints have been a feature mainly of the minerals and metals market. Investment and capacity growth in this commodity group had been slow for many years due to a long period of low prices in the 1990s. This seems to have been changing since 2002 as a reaction to rising prices, which has led to a substantial increase in expenditures on worldwide exploration. In 2006 these expenditures grew by 47 per cent, reaching their highest level since 1990. However, exploration activity may not have grown at the same rate due to its higher costs (Metals Economics Group, 2007). This, together with the long lead times for production to come on-stream, implies that the supply of metals and minerals has not been able to keep pace with the rapid demand growth. Consequently, inventories shrunk to historically low levels, although some commodities such as copper saw a slight recovery by the end of the year. High prices continue to provide incentives for increased investment in mining. However, the price of some metals declined somewhat in late 2006 and early 2007 as a result of destocking of copper in China – which reduced demand for imports – and an increase in China's supply of zinc and aluminium, of which it is a major world producer. This reflects China's strong influence on commodity markets and prices, both from the demand and the supply side. But the remaining tightness in most minerals and metals markets means that any supply disruption could lead to a dramatic increase in prices, as happened in the case of tin when the Government of Indonesia, which is the largest tin producer in the world, decided to shut down a number of illegal smelting plants. Additionally, in 2006 markets for some agricultural commodities were affected on the supply side by unfavourable weather conditions, such as drought in Australia, which contributed to soaring grain prices, mainly of wheat.

Energy prices, mostly of crude petroleum, have influenced the price trends of many other commodities in recent years. Crude petroleum

prices remained high and volatile during 2006, peaking in July–August. Their subsequent decline was related to weather conditions, such as the mild winter in the North and a hurricane season that was less violent than expected, as well as to a relative easing of geopolitical tensions and a build-up of inventories. It may also have been helped by sell-offs of commodity-related assets in financial markets. Moreover, substitution effects from the use of other energy sources in consuming developed countries as a result of the high petroleum prices were partly responsible for the slower average growth of oil prices in 2006. British Petroleum (2007) reports that global oil consumption grew by 0.7 per cent in 2006, which is the weakest growth since 2001. OECD oil consumption declined by 0.9 per cent, but this was more than compensated by a 6.7 per cent growth in Chinese oil consumption. At the same time, global oil production grew by 0.4 per cent. On the whole, even with slower growth in the global demand for oil, market conditions remain tight, with spare capacity of the members of the Organization of the Petroleum Exporting Countries (OPEC) at very low levels. This is making the market vulnerable to a supply disruption, which could drive prices significantly upwards, as witnessed in early 2007 when the decline in crude petroleum prices was reversed after January, due to the cold weather and to moderate production cuts by OPEC countries as a reaction to the previously low demand and to prevent a further drop in the price. Forecasts by the International Energy Agency (IEA, 2007) of rising demand for oil, as well as heightening geopolitical tensions in the Middle East and conflicts in some major oil-producing countries, such as Nigeria, have further contributed to the upward pressure on oil prices.

The current high prices of crude petroleum have led to increased demand and to higher prices of commodities whose market developments are strongly correlated with those of oil. The prices of natural rubber rose sharply, by 40.4 per cent, in 2006 due to higher demand for it as a substitute for the more expensive synthetic rubber produced from oil. As noted earlier, an increasingly important factor driving up the prices of some agricultural commodities is the push in demand for biofuels as an alternative energy source. The strong demand for biofuels has been a response not only to high crude petroleum prices but also to growing

concerns about global climate change. The commodities the most affected by this increase in demand have been sugar and maize, which are used for ethanol production, and vegetable oils for biodiesel. For instance, in 2006, sugar prices increased by 49.4, maize prices by 24.4 per cent and palm oil by 13.3 per cent. Although the expansion of land used for the production of biofuels has increased the supply of agricultural commodities, leading to some easing of prices in early 2007, the outlook is for a continuing and rapid increase in demand for biofuels (European Commission, 2007; FAO, 2007).

In addition to being environmentally friendly in terms of carbon emissions, the production of biofuels may be economically beneficial to developing countries, as it may help reduce their oil import bills and increase their export earnings. It may also offer improved energy security through diversification of energy sources, as well as providing opportunities to diversify agricultural output. This could ultimately give a boost to development in rural areas by increasing rural employment and incomes. In general, developing countries have a competitive advantage in biofuel production. For instance, producing ethanol from sugar cane in Brazil is more efficient in economic and environmental terms than producing it from maize in the United States. However, developed countries are promoting local production and limiting access to their markets through support policies in the form of subsidies for their producers and high import tariff protection. Moreover, concerns have been raised in relation to competing uses of land for the production of food, animal feedstock and biofuels. For instance, increasing the land under maize production in the United States has displaced land for soybeans, the prices of which have been rising sharply since mid-2006, although the yearly average shows a slight decline. This in turn has led to higher prices for animal feedstock and meat. The higher food prices can have dramatic consequences for food-importing developing countries. There are also concerns that the effects on deforestation, water scarcity and biodiversity as a result of bringing increased land under cultivation may offset the environmental benefits of biofuel production. A possible solution may come from obtaining biofuels from tropical plants, such as the jatropha tree, which can grow in degraded land and would therefore

not compete with other uses yet have a positive environmental impact (UNCTAD, 2007b; UNCTAD, 2006).²

Soaring commodity prices have aroused growing interest in commodities by financial investors, including speculators. Even though the magnitude of investments in commodities as a financial asset is difficult to measure, there are indications that it has been huge in recent years (Doyle, Hill and Jack, 2007). According to Domanski and Heath (2007), commodity markets have become more like financial markets in terms of the motivations and strategies of participants, but the physical characteristics of the markets are still important. An illustration of the growing interest in commodity investment is the volume of commodity futures and options traded globally, which grew faster than in other markets in 2006. The volume of global futures and options in agricultural commodities increased by 28.4 per cent, in energy commodities by 37.8 per cent and in metals by 27.8 per cent. Furthermore, commodity exchanges in China and India are becoming major players in global commodity trade (Burghardt, 2007). Even though interest in commodities as a financial asset remained strong in 2006, there are some indications of a possible change in the attitude of financial investors vis-à-vis commodities, reflected in the market correction of January 2007. As more and more investors have moved into commodities, the incentive for diversifying portfolios (i.e. the negative price correlation of commodities with other financial assets) may be weakening. Typically, commodity markets are in backwardation (i.e. their spot price is higher than the futures contract price), allowing investors to earn a positive roll return when the contract is close to maturity. More recently, some commodity markets have been in contango (i.e. when spot prices are lower than futures prices) leading to negative roll yields on investment. According to media reports, commodity indices have been performing poorly since mid-2006. For instance, the Goldman Sachs Commodity Index and the Reuters/Commodity Research Bureau Commodity Index registered losses of 15.1 and 7.4 per cent, respectively, in 2006 (*Financial Times*, 11 January 2007; *Forbes Magazine*, 29 January 2007). In any case, the increased participation of financial investors in commodity investment has added an element of volatility to commodity markets.

The outlook is for commodity prices to remain high for some years on account of solid demand for commodities in rapidly growing developing countries, even though global economic growth is expected to slow somewhat. But the rates of growth of commodity prices may decelerate as new supplies enter the markets. However there is no clear understanding as to when this might happen, particularly for metals and minerals. Supply response will be much faster for some agricultural commodities, which will also be subject to volatility due to weather conditions. China will continue to play a key role in commodity markets, not only from the demand side but also from the supply side. According to some reports, the Chinese Government might even be considering investing part of its foreign exchange reserves in increasing its strategic commodity reserves (Derrick, 2007). Thus there seems to be a structural change in commodity markets, which indicates that prices are not likely to slump because of supply-side factors. Consequently, commodity prices are likely to remain above the long-run declining trend in real terms, but it would be too optimistic to conclude that there might soon be a reversal of this trend.

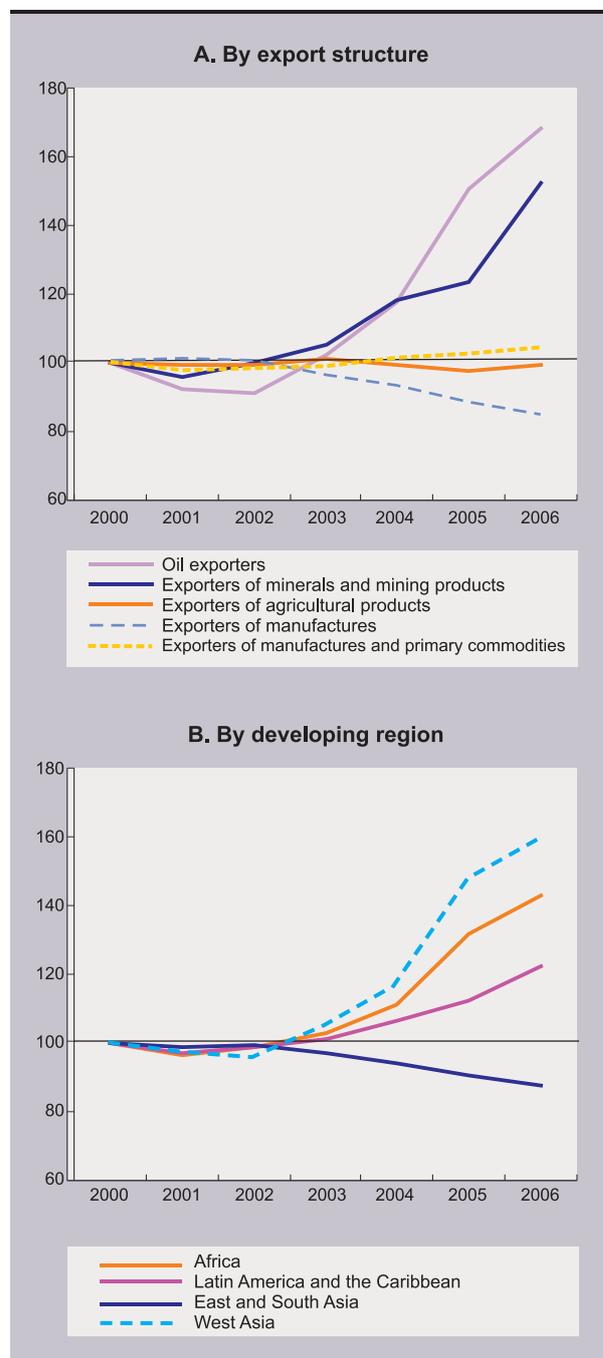
(c) Evolution of the terms of trade

In 2006, the terms of trade in developing countries followed a similar trend as in previous years (see *TDR 2005*, chap. III, section C, and *TDR 2006*, annex 1 to chap. I). There were significant gains for oil- and mineral-exporting countries, a deterioration in the terms-of-trade for exporters of manufactures, and relative stability for countries with more diversified exports (comprising mainly manufactures but also some primary commodities) and for the exporters of agriculture products (fig. 1.2A). In the latter case, this apparent stability is the result of divergent trends within the group, relating to the evolution of the prices of their export products, but also to the relative weight of oil in their imports. Among this group, those that have been the most vulnerable from terms-of-trade changes have been the oil-importing countries whose exports are concentrated in a few primary commodities that are subject to price volatility. The other group of developing countries affected by changes in the terms of trade (i.e. the exporters of manufactures) were able, in gen-

Figure 1.2

NET BARTER TERMS OF TRADE, SELECTED DEVELOPING COUNTRIES, 2000–2006

(Index numbers, 2000 = 100)



Source: UNCTAD secretariat calculations, based on UN COMTRADE; United States Department of Labor, Bureau of Labor Statistics, *Import/Export Price Indexes* database (www.bls.gov/mxp/home.htm); Japan Customs, *Trade Statistics* database (www.customs.go.jp); IMF, *International Financial Statistics* database; UNCTAD, *Commodity Prices Bulletin*, various issues; and ECLAC, *Balance of Payments Statistics* database.

Table 1.5

IMPACT OF CHANGES IN TERMS OF TRADE AND NET INCOME PAYMENTS ON NATIONAL DISPOSABLE INCOME IN SELECTED DEVELOPING-COUNTRY GROUPS, AVERAGE FOR 2004–2006

(Per cent of GDP)

	Effects from changes in terms of trade	Effects from changes in net income payments	Net impact
Africa	1.9	-1.0	0.9
Latin America	2.1	-0.7	1.4
East and South Asia	-1.5	-0.2	-1.7
West Asia	4.9	0.2	5.1
Exporters of manufactures	-1.2	-0.1	-1.2
Oil exporters	7.3	-0.2	7.0
Exporters of minerals and mining products	5.7	-4.6	1.2
Other commodity exporters	-0.2	-0.1	-0.3

Source: UNCTAD secretariat calculations, based on United Nations Statistics Division, *United Nations Common Database* (UNCDB); IMF, *Balance of Payments Statistics* database; ECLAC, *Balance of Payments Statistics* database; national sources; and UNCTAD estimates of unit value and volume of exports and imports.

Note: For an explanation of net income payments, see text.

eral, to compensate for loss due to price changes by expanding their volume of export.

These trends are reflected in the different developing regions: East, South and South-East Asia (where manufactures constitute the largest share of exports) saw a further deterioration in their terms of trade; West Asia and Africa experienced sharp increases (mainly in the oil exporting countries of those regions); and Latin America and the Caribbean recorded moderate but still significant gains. These aggregate outcomes conceal wide differences within each group: in developing America most South American countries posted gains in their terms of trade, while several Cen-

tral American and Caribbean countries suffered losses. In Africa, the terms of trade improved particularly in the oil-rich sub-regions (North Africa, West Africa and Middle Africa), while countries in Eastern and Southern Africa showed mixed results; and in West Asia, there were wide differences between the oil and gas exporters of the Gulf States and those exporting mainly manufactures, such as Jordan and Turkey (fig. 1.2).

The economic impact of changes in the terms of trade depends on several factors. One is the degree of openness of the economy: in a very closed economy, wide changes in unit prices of exports and imports will have little real effects, but in more open economies, changes in the terms of trade may represent fairly significant gains or losses of real domestic income as a percentage of GDP. Table 1.5 presents an estimate of the impact of changes in the terms of trade of different groups of developing countries, by region and export structure. Between 2004 and 2006 income gains from the changes in the terms of trade have been extremely high in oil- and mineral-exporting countries, exceeding 7 and 5 percentage points of GDP per year, respectively, while exporters of manufactures suffered losses close to one percentage point of GDP on average. Other commodity exporters showed, on average, no gains or losses. In aggregate, all the developing regions gained, with the exception of East, South and South-East Asia.

In some cases, however, windfall gains from the terms of trade may have been offset by increased profit remittances by TNCs involved in the exploitation of natural resources. In those cases, the gross *national* income will have grown at a lower rate than the gross *domestic* income. This has been the case in Africa and Latin America, particularly in countries where foreign companies account for a large proportion of their export-oriented production, and where the taxation system is extremely favourable to private firms in the extractive industries. As shown in table 1.5, higher net income payments to non-residents drained most of the terms-of-trade-related income gains of mineral exporters between 2004 and 2006.

B. Global imbalances and destabilizing speculation

As extensively discussed in past *Trade and Development Reports (TDRs 2004, 2005 and 2006)*, global imbalances have become a major source of systemic risk to the global economy. They can have adverse repercussions in the short and long term on both surplus and deficit economies due to the potentially disruptive effect of a sudden adjustment. As in past financial crises, the growing financial fragility induced by some types of capital inflows, associated with current-account deficits and the threat of an overshooting devaluation, may force deficit economies into contraction, which may spill over to trading partners.

However, the number of emerging-market economies with current account deficits is rather small this time and the weight of those countries in the world economy is rather light. Nevertheless, there are some spots where risks of a crisis are high like in Eastern Europe and in some transition countries in Asia. Despite the diversity of the sources of imbalance, the existence of weak financial systems, institutions and regulations are mentioned frequently; the determinants of overall competitiveness, such as wage growth overshooting productivity growth by a wide margin and movements of the nominal exchange rate play the most important role in triggering speculative capital flows.

National and international policies need to address the major sources of imbalance by providing an institutional framework that would reduce the potential for speculative flows and promote coordinated efforts for exchange-rate adjustment and stable and competitive real exchange rates for developing countries.

1. Widening global imbalances

The sources, sustainability and possible adjustment mechanisms of the widening external imbalances have been the object of one of the liveliest and most controversial economic policy debates of the past couple of decades. Obviously, trade flows are not “imbalanced” per se if the in- and outflows to and from a country vis-à-vis the rest of the world do not offset each other within a given period. For some observers the fact that imbalances correspond to a real transfer of resources from surplus countries to deficit countries, is just a natural and harmless implication of an increasingly integrated global economy. That is why the Council of Economic Advisors called the United States current account deficit a “capital import surplus” (*TDR 2006: 9*).

However, the actual pattern and level of the imbalances are a source of concern for those who believe that the size of any transfer of resources should remain within the expected long-run capacity to pay interest and the principal (*TDR 2006; UN-DESA/UNCTAD, 2007*). In fact, the size and direction of net capital flows for many years following the shocks of the deep financial crises in Asia, Latin America and some transition economies, tend to support the belief that there is a problem with the global imbalance adjustment mechanism. Among those sharing this view, is a perception that an adjustment is imminent and can be either “soft” (i.e. with a smooth, policy-induced correction) or “hard” (i.e. with a painful contraction and crisis in deficit countries and major adverse repercussions on surplus countries).

Nonetheless, there is an almost universally shared belief that changes in the overall competitiveness of an economy can be a decisive factor in reversing the sign of its trade balance. Indeed, large corrections of deficits are usually observed to go hand in hand with huge devaluations of the nominal and real exchange rate, and empirical evidence has shown that changes in the real effective exchange rate (REER) – the most comprehensive measure of the overall competitiveness of nations (*TDR 2004*) – have the potential to reduce deficits or to induce swings in the trade and current account from deficit to surplus (IMF, 2007; Deutsche Bundesbank, 2007).³

A depreciation of the real exchange rate, more than anything else, induces an “expenditure switch” from demand for foreign goods to demand for domestic goods, which is reflected in an improvement in the trade balance, and vice versa in the case of an appreciation. The swing from deficit to surplus in many crisis-stricken countries in Asia and Latin America was associated with huge devaluations of their currencies and large gains in competitiveness for their economies as a whole. This nexus between the exchange rate and trade flows is also acknowledged by those who believe that if the Chinese currency, the renminbi, were allowed to float freely, it would reduce the biggest surplus in the world and the biggest deficit at the same time.

Given this, few would question that a large or even rising current account deficit accompanied by a real appreciation and a loss in overall competitiveness is a much stronger indicator for non-sustainability than a deficit without this. The other way round in surplus countries: Their currencies should be candidates for an appreciation in real terms and not depreciate. If the most important price for exports and imports, the real exchange rate, consistently moves into the “wrong” direction, there is hardly an easy way out of a protracted imbalance. In other words, such “false” price movements have to be avoided at all costs to allow the world economy to smoothly correct its global imbalances.⁴

But this “false pricing” is exactly what happens in many regions of the world. Looking roughly at the time pattern of the ratio of the current-account to GDP and the REER for some selected economies reveals “false pricing” to be a

rather common phenomenon (table 1.6). Economies are grouped according to the size of their current-account surplus or deficit. Countries with a large surplus include oil exporters such as the Russian Federation and Saudi Arabia, and exporters of manufactures, such as China, Germany, Japan, Malaysia and Switzerland. Many East Asian and Latin American emerging market economies enjoy a small surplus, while members of the euro area, Mexico and Colombia register a slight deficit. Significant and persistent deficits are observable in South Africa, Turkey, Australia and New Zealand as well as Hungary and other East European oil importing countries. The United States current account reached a record deficit of 6.6 per cent of its GDP in 2006, or more than \$850 billion.⁵

Table 1.6 also shows the paradox of false pricing for a number of surplus economies with officially floating exchange rates: Japan had a significant real depreciation, while it was smaller for Germany and Switzerland. China, the country most under political pressure to float its currency, shows a much stronger tendency towards appreciation than the free floaters. Under a floating regime and high mobility (and low regulation) of capital, the nominal and real exchange rates can move in the wrong direction from a balance-of-payments point of view, thereby hindering the adjustment process and making the constellation of deficits and surpluses unsustainable.

This suggests that a shift to floating and capital openness may not provide a solution to the global imbalances, and, more generally, raises questions about the role of the financial system in the determination of capital flows, nominal and real exchange rates and real imbalances. Indeed, various forms of domestic and international financial speculation have been associated with episodes of consumption booms, current-account deficits and overvalued currencies. If speculation is an important source of real exchange rate misalignments and of persistent diverging patterns of global real balances, domestic and international regulations and policies have to provide the conditions for generating converging patterns of trade balances and a coherent adjustment of the imbalances.

The following section describes how speculative capital flows, concomitant false pricing and

the resulting misalignments are induced by short-term interest rate differentials and floating currencies in perfectly open markets. In light of the evidence, both policy targets for exchange rates and a new assignment of monetary and non-monetary instruments at the national level need to be reconsidered.

2. *Speculative flows induced by “carry trade”*

In the past couple of years a widespread and persistent speculative phenomenon involving currencies of developed and developing countries with large short-term interest rate differentials has drawn considerable attention from the media and financial analysts as well as concerns by central bankers. “Carry trade” has become a catchphrase to define the specific financial operation of borrowing and selling a low-yielding currency to buy and lend in a high-yielding currency. For example, an established speculator such as a hedge fund might borrow 12,000 yen in Japan and buy \$100 in the United States, invest this amount in United States bonds and obtain an interest revenue equal to the difference between the borrowing rate in Japan, say 0.25 per cent, and the higher lending rate in the United States, say 5 per cent. Exchange-rate changes between the time of borrowing and paying back the funding currency can add to the gains, or induce smaller gains or even losses. But with stable exchange rates, the *interest rate gain* amounts to 4.75 per cent. However, both gains and losses are largely magnified by high leverage ratios, since traders typically use huge amounts of borrowed funds and very little equity. For instance, owning a capital of \$10 and borrowing 10 times the equivalent of that value in yen, the leverage factor of 10 leads to a net interest return on equity of 47.5 per cent.

This simple and hardly new form of speculation may appear too straightforward to be possible in highly developed and integrated capital markets, yet it has represented a substantial source of profits, inducing huge amounts of capital flows and pressure on exchange rates since the collapse of the Bretton Woods system in the early 1970s. It has gained a new quantitative dimension, since

more or less unregulated funds have virtually unlimited access to massive pools of capital from pension funds or wealthy citizens.

Carry trade is fundamentally based on the expectation that, given a sufficiently large interest rate differential between the borrowing and the lending currency – which is quasi fixed by monetary policies in both countries – the exchange rate will either remain stable or move in a favourable direction, or allow a major withdrawal from the currency before profits are fully eroded. On the other hand, in today’s markets, the volume of speculative flows stemming from these funds is so large that they have a direct effect on the exchange rate, thereby creating a self-fulfilling expectation of profit in excess of the interest rate differential. In the example cited above, a devaluation of the yen and a revaluation of the dollar induced by carry trade would increase the net return on equity well beyond 47.5 per cent.

This implies that national policies aimed at fighting domestic inflation by rising interest rates may end up providing strong incentives to this kind of speculation if other countries have different inflation and interest rates. The ensuing over- or undervaluation may offset or magnify the effects of the desired monetary policies, generating financial fragility and huge real adjustment costs to the national economy and the global economic system. The fundamental mechanism of real-exchange-rate adjustment that, according to widespread political expectations, would allow a smooth correction of the imbalances would be undermined. Flows moving from low-yielding, low-inflation countries to high-yielding, high-inflation countries would cause the currencies of the latter to appreciate, and provoke the paradoxical and dangerous combination of surplus economies experiencing pressures to depreciate, and deficit countries facing a similar pressure to appreciate.

Carry trade has recently involved mostly high- and medium-income economies such as Australia, Iceland, Japan, New Zealand, Switzerland and the United States, and a few emerging market economies such as Brazil and Turkey, as well as some Central and Eastern European economies such as Hungary, Romania, Bulgaria and the Baltic States. Over the past two years, yen- and Swiss franc-funded carry trade operations appeared to be re-

Table 1.6

**REAL EFFECTIVE EXCHANGE RATE (1996 = 100) AND CURRENT-ACCOUNT (C/A) BALANCE,
SELECTED ECONOMIES, 1996–2006**

<i>Economy</i>	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Economies with current-account surplus											
Economies with large current-account surplus											
China											
REER	100.0	106.8	112.4	106.3	109.2	114.6	111.9	106.6	105.1	107.5	109.9
C/A balance (\$ billion)	7.2	34.4	31.6	15.7	20.5	17.4	35.4	45.9	68.7	160.8	238.5
C/A balance as per cent of GDP	0.8	3.6	3.1	1.4	1.7	1.3	2.4	2.8	3.6	7.2	10.3
Japan											
REER	100.0	94.6	94.8	103.8	107.4	96.3	90.0	89.1	89.4	84.7	78.7
C/A balance (\$ billion)	65.7	96.6	119.1	114.5	119.6	87.8	112.6	136.2	172.1	165.7	170.5
C/A balance as per cent of GDP	1.4	2.3	3.1	2.6	2.6	2.1	2.9	3.2	3.8	3.6	3.9
Germany											
REER	100.0	94.1	94.1	91.1	84.8	84.8	85.6	90.1	91.3	90.7	90.5
C/A balance (\$ billion)	-14.0	-10.0	-16.3	-26.9	-32.6	0.4	41.0	45.6	117.9	129.0	147.0
C/A balance as per cent of GDP	-0.6	-0.5	-0.7	-1.3	-1.7	0.0	2.0	1.9	4.3	4.6	5.1
Russian Federation											
REER	100.0	109.0	96.2	63.4	70.7	85.3	89.3	92.3	99.1	109.0	119.8
C/A balance (\$ billion)	10.8	-0.1	0.2	24.6	46.8	33.9	29.1	35.4	58.6	83.6	94.5
C/A balance as per cent of GDP	2.8	-0.0	0.1	12.6	18.0	11.1	8.4	8.2	9.9	10.9	9.6
Saudi Arabia											
REER	100.0	106.2	112.9	109.8	110.6	114.5	113.0	104.3	97.0	94.2	93.1
C/A balance (\$ billion)	0.7	0.3	-13.1	0.4	14.3	9.4	11.9	28.1	52.0	90.8	95.5
C/A balance as per cent of GDP	0.4	0.2	-9.0	0.3	7.6	5.1	6.3	13.1	20.7	29.3	27.0
Switzerland											
REER	100.0	92.2	96.1	96.0	89.7	92.6	98.1	99.7	97.7	94.1	89.9
C/A balance (\$ billion)	22.0	25.5	26.1	29.4	30.7	20.0	23.0	43.0	50.5	61.0	63.5
C/A balance as per cent of GDP	7.3	9.7	9.7	11.1	12.4	8.0	8.3	13.3	14.1	16.5	16.8
Malaysia											
REER	100.0	96.8	79.7	78.9	79.3	83.3	83.2	79.6	76.4	75.5	75.5
C/A balance (\$ billion)	-4.5	-5.9	9.5	12.6	8.5	7.3	8.0	13.2	14.9	19.9	25.6
C/A balance as per cent of GDP	-4.4	-5.9	13.2	15.9	9.4	8.3	8.4	12.7	12.6	15.2	16.9
Economies with small current-account surplus											
Brazil											
REER	100.0	105.0	104.8	78.3	93.0	83.9	83.6	91.4	98.5	120.1	130.4
C/A balance (\$ billion)	-23.5	-30.5	-33.4	-25.3	-24.2	-23.2	-7.6	4.2	11.7	14.2	13.3
C/A balance as per cent of GDP	-3.0	-3.8	-4.2	-4.7	-4.0	-4.5	-1.7	0.8	1.9	1.8	1.2
Republic of Korea											
REER	100.0	93.0	74.2	82.9	88.5	79.9	82.5	82.1	84.5	93.2	99.2
C/A balance (\$ billion)	-23.1	-8.3	40.4	24.5	12.3	8.0	5.4	11.9	28.2	16.6	6.1
C/A balance as per cent of GDP	-4.1	-1.6	11.7	5.5	2.4	1.7	1.0	2.0	4.1	2.1	0.7
Chile											
REER	100.0	104.4	100.6	97.9	102.6	97.0	95.3	94.1	102.4	111.3	119.0
C/A balance (\$ billion)	-3.1	-3.7	-3.9	0.1	-0.9	-1.1	-0.6	-1.0	1.6	1.3	5.3
C/A balance as per cent of GDP	-4.1	-4.4	-5.0	0.1	-1.2	-1.6	-0.9	-1.3	1.7	1.2	3.9
Argentina											
REER	100.0	104.9	107.9	114.0	111.8	117.3	63.8	69.9	68.2	67.5	65.6
C/A balance (\$ billion)	-6.8	-12.1	-14.5	-11.9	-9.0	-3.3	8.7	8.0	3.3	5.6	8.0
C/A balance as per cent of GDP	-2.5	-4.1	-4.8	-4.2	-3.2	-1.2	8.9	6.3	2.2	3.1	3.7
Indonesia											
REER	100.0	92.9	48.5	74.5	71.9	69.2	83.4	88.3	82.0	82.9	102.2
C/A balance (\$ billion)	-7.3	-3.8	4.0	5.8	8.0	6.9	7.8	8.1	1.6	0.9	9.7
C/A balance as per cent of GDP	-2.9	-1.6	3.8	3.7	4.8	4.3	4.0	3.5	0.6	0.3	2.7

Table 1.6 (concluded)

<i>Economy</i>	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Economies with current-account deficit											
<i>Economies with small current-account deficit</i>											
Mexico											
REER	100.0	113.5	114.4	125.0	138.1	145.9	147.1	136.8	135.7	142.5	146.4
C/A balance (\$ billion)	-2.5	-7.7	-16.0	-13.9	-18.7	-17.7	-13.5	-8.6	-6.6	-4.8	-1.9
C/A balance as per cent of GDP	-0.8	-1.9	-3.8	-2.9	-3.2	-2.8	-2.1	-1.4	-1.0	-0.6	-0.2
Colombia											
REER	100.0	106.4	99.8	90.6	83.1	80.5	79.1	70.5	77.1	87.5	86.1
C/A balance (\$ billion)	-4.6	-5.8	-4.9	0.7	0.8	-1.1	-1.4	-1.0	-0.9	-1.9	-2.9
C/A balance as per cent of GDP	-4.8	-5.4	-4.9	0.8	0.9	-1.3	-1.7	-1.2	-0.9	-1.6	-2.2
Euro area											
REER	100.0	91.4	93.7	91.0	83.6	84.8	87.9	97.9	101.5	100.6	101.3
C/A balance (\$ billion)	..	56.9	23.0	-34.0	-91.7	-19.3	50.3	36.6	61.8	-28.8	-20.1
C/A balance as per cent of GDP	..	0.9	0.3	-0.5	-1.5	-0.3	0.7	0.4	0.6	-0.3	-0.2
<i>Economies with large current-account deficit</i>											
Hungary											
REER	100.0	108.3	108.8	106.5	106.0	113.0	119.4	121.6	125.5	125.9	122.0
C/A balance (\$ billion)	-1.8	-2.0	-3.4	-3.8	-4.0	-3.2	-4.6	-7.2	-8.7	-8.1	-6.2
C/A balance as per cent of GDP	-3.9	-4.5	-7.2	-7.8	-8.5	-6.1	-7.1	-8.7	-8.6	-7.4	-5.6
New Zealand											
REER	100.0	102.0	90.4	86.8	78.0	77.4	86.7	101.7	109.6	115.2	105.9
C/A balance (\$ billion)	-3.9	-4.3	-2.1	-3.5	-2.7	-1.4	-2.4	-3.4	-6.5	-9.6	-9.4
C/A balance as per cent of GDP	-5.8	-6.4	-3.9	-6.2	-5.2	-2.8	-4.1	-4.3	-6.7	-8.9	-9.0
South Africa											
REER	100.0	105.7	95.8	92.0	90.6	82.2	73.4	97.6	106.6	107.5	101.5
C/A balance (\$ billion)	-1.7	-2.2	-2.4	-0.7	-0.2	0.1	0.7	-2.2	-7.4	-10.1	-16.3
C/A balance as per cent of GDP	-1.2	-1.5	-1.8	-0.5	-0.1	0.1	0.6	-1.3	-3.4	-4.2	-6.5
India											
REER	100.0	104.3	99.5	99.4	101.2	103.5	99.9	99.5	100.5	103.7	100.4
C/A balance (\$ billion)	-6.0	-3.0	-6.9	-3.2	-4.6	1.4	7.1	8.8	0.8	-6.9	-19.3
C/A balance as per cent of GDP	-1.6	-0.7	-1.7	-0.7	-1.0	0.3	1.4	1.5	0.1	-0.9	-2.1
Turkey											
REER	100.0	101.1	101.1	99.4	107.8	96.0	108.8	118.6	124.6	132.7	128.9
C/A balance (\$ billion)	-2.1	-2.1	2.0	-1.3	-9.8	3.4	-1.5	-8.0	-15.6	-23.1	-31.5
C/A balance as per cent of GDP	-1.2	-1.1	1.0	-0.7	-5.0	2.4	-0.8	-3.3	-5.2	-6.4	-8.0
Australia											
REER	100.0	104.0	96.8	97.6	93.5	89.1	92.7	103.2	112.7	119.0	123.6
C/A balance (\$ billion)	-15.7	-12.4	-18.4	-22.4	-15.2	-7.7	-16.2	-29.5	-40.1	-42.2	-40.6
C/A balance as per cent of GDP	-3.8	-3.0	-4.9	-5.6	-3.9	-2.1	-3.9	-5.6	-6.3	-6.0	-5.4
United Kingdom											
REER	100.0	114.1	119.0	117.0	114.7	111.5	112.7	109.6	114.5	111.7	111.4
C/A balance (\$ billion)	-10.5	-1.4	-5.3	-35.1	-37.6	-31.5	-24.8	-24.4	-35.4	-48.3	-80.0
C/A balance as per cent of GDP	-0.9	-0.1	-0.4	-2.4	-2.6	-2.2	-1.6	-1.3	-1.6	-2.2	-3.5
United States											
REER	100.0	104.5	113.7	113.8	115.0	122.0	122.0	112.7	105.8	102.9	99.8
C/A balance (\$ billion)	-124.8	-140.4	-213.5	-299.8	-415.2	-389.0	-472.4	-527.5	-665.3	-791.5	-869.1
C/A balance as per cent of GDP	-1.6	-1.7	-2.4	-3.2	-4.2	-3.8	-4.5	-4.8	-5.7	-6.4	-6.6
EU – Central and Eastern Europe ^a											
REER	100.0	104.4	110.6	106.1	111.0	119.5	122.1	121.0	125.9	136.2	142.6
C/A balance (\$ billion)	-14.4	-16.6	-18.6	-22.3	-20.3	-16.7	-18.5	-23.8	-37.5	-31.3	-38.8
C/A balance as per cent of GDP	-4.1	-4.7	-4.9	-6.0	-5.5	-4.1	-4.1	-4.4	-5.8	-4.1	-4.7

Source: UNCTAD secretariat calculations, based on IMF, *Balance of Payment Statistics*; and *International Financial Statistics* databases; and JP Morgan through Thomson Financial DataStream database.

^a Czech Republic, Estonia, Hungary, Lithuania, Poland, Romania, Slovakia and Slovenia.

sponsible for the large volatility and gyrations of some of the high-yielding currencies, such as the New Zealand and Australian dollars, the Hungarian forint and the Icelandic krona. The latter experienced typical crisis symptoms: prolonged periods of steady appreciation and capital inflows, disrupted by shorter periods of sharp devaluations as carry traders unwound their positions. This happened in Iceland, for example, between March and May 2005, February and April 2006, November 2006 and January 2007. Other countries, such as Brazil, have experienced a steady appreciation of their currencies in the last few years despite fairly high inflation rates.

According to the Bank for International Settlements (BIS, 2007), hedge funds have been the main players and the main beneficiaries of trades using the yen and Swiss franc as funding currencies for buying assets in some of the countries mentioned above. A comparison of carry-to-risk ratios (the three-month interest rate differential divided by the implied volatility of the currency option) provides further evidence that there is a clear tendency for the currencies of some developing countries like the Brazilian real and the Turkish lira to become increasingly more attractive than traditional carry trade targets such as the Australian and New Zealand dollars and the pound sterling. However, speculative flows are difficult to identify and monitor. As noted in the BIS study, measuring the volume of carry trade is problematic because of lack of data and the variety of forms that these flows can take.

The specific episodes of carry trade deserve attention as warning signals that even financially developed medium- to high-income countries are not immune to destabilizing capital flows. Besides that, the phenomenon may be regarded as a “species” of the broader “genus” of potentially destabilizing speculative capital-account operations; it displays numerous similarities with the mechanisms that caused financial fragility in many emerging markets, leading thereafter to currency and financial crises in the mid-1990s. The more general mechanisms of destabilizing speculation, on the other hand, may easily involve emerging markets and small, open developing economies that have access to capital markets and adopt different monetary policies due to differing inflation histories.

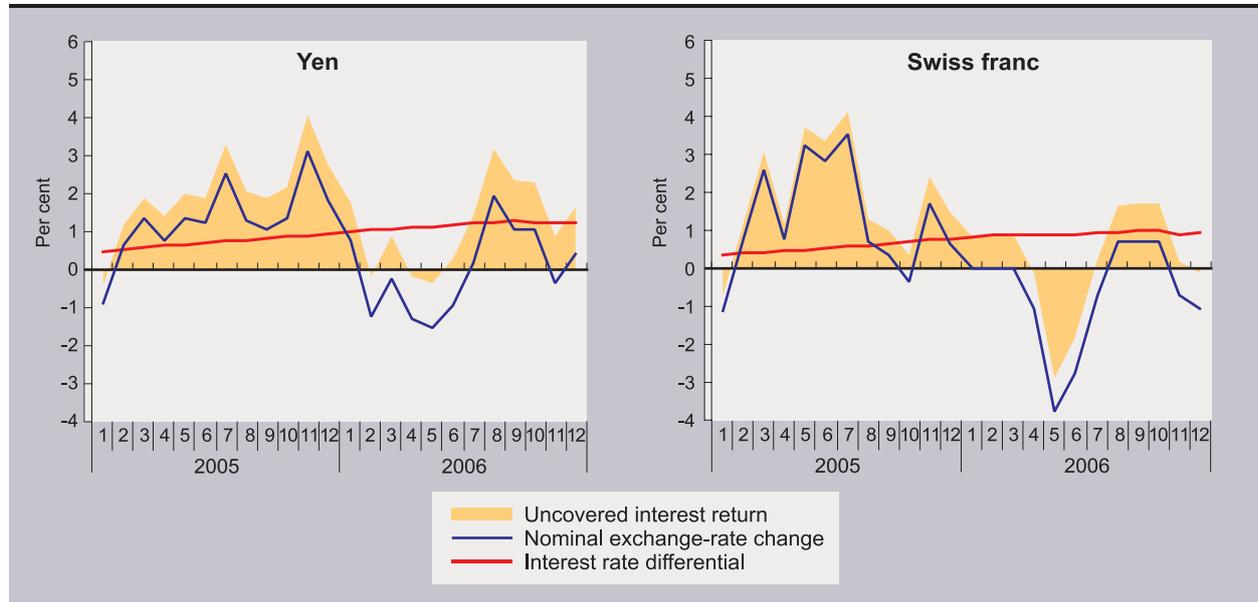
While such speculative operations naturally involve a currency risk for speculators, that can be attenuated by diversifying the portfolio of high-yielding currencies, the risk for both the funding and lending currencies cannot be diversified, and can therefore become a source of “systemic risk”, spilling over from the financial system to the real economy. The web of different funding and lending currencies of otherwise unrelated economies causes the countries involved to become interdependent and subject to reversals of perceptions and to contagion effects.

Contagion spreads due to speculators’ profit maximization motives: unwinding of positions in one country affects all the web-related economies. Such unwinding may be triggered by “conventional focal points” such as the external balance or growth, or the inflation prospects of the funding currency causing fear of an interest rate correction and an exchange-rate jump. For instance, it has been debated as to whether the speculative run on the Icelandic krona was triggered by the perceived non-sustainability of the huge current-account deficit, by a downgrade from some rating agency, or even by a piece of “good news” related to the funding currency, such as an improvement in the Japanese economy which had the potential of leading to an interest rate increase and an appreciation of the yen. Undoubtedly, the carry trade unwinding from the krona had a significant impact not only on the Icelandic financial and credit system, but also on some third parties involved, namely some emerging markets, as traders needed to cash in some of their earnings from well-performing currencies to cover some of their losses from the krona trade.

Figure 1.3 shows past carry trade potentials driven by the nominal exchange-rate dynamics and interest rate differentials between the dollar and the yen (left chart) and between the dollar and Swiss franc (right chart). The red line represents the 3-month interest rate differential between the dollar- and yen- or Swiss franc-denominated assets; the blue line is the exchange-rate change of the dollar vis-à-vis the yen and the Swiss franc, while their sum (the shaded area) is the return on a 3-month (uncovered) lending in the United States by borrowing in Japan or Switzerland in local currencies. Since this return carries the risk of exchange-rate changes, it is hereafter called “uncovered interest return” (UIR).

Figure 1.3

CARRY TRADE OPPORTUNITIES OF THE YEN AND SWISS FRANC VIS-À-VIS THE DOLLAR, 2005–2006



Source: UNCTAD secretariat calculations, based on IMF, *International Financial Statistics* database; and national sources.

Note: For an explanation of how the uncovered interest return is calculated, see text. A positive change in the exchange rate signifies an appreciation of the currency concerned.

While uncovered gains and losses can be significant, their volatility depends entirely on fluctuations in the nominal exchange rate. Periods of relative stability and large interest rate differentials provide a strong incentive to traders, as in 2005 and mid-2006. During that period the dollar appreciated vis-à-vis the two funding currencies, despite high and rising current-account deficits and higher inflation rates in the United States than in Japan or Switzerland. On the other hand, sudden exchange-rate reversals, as in early 2006, can trigger a large unwinding of investments and this can spill over to emerging market economies.

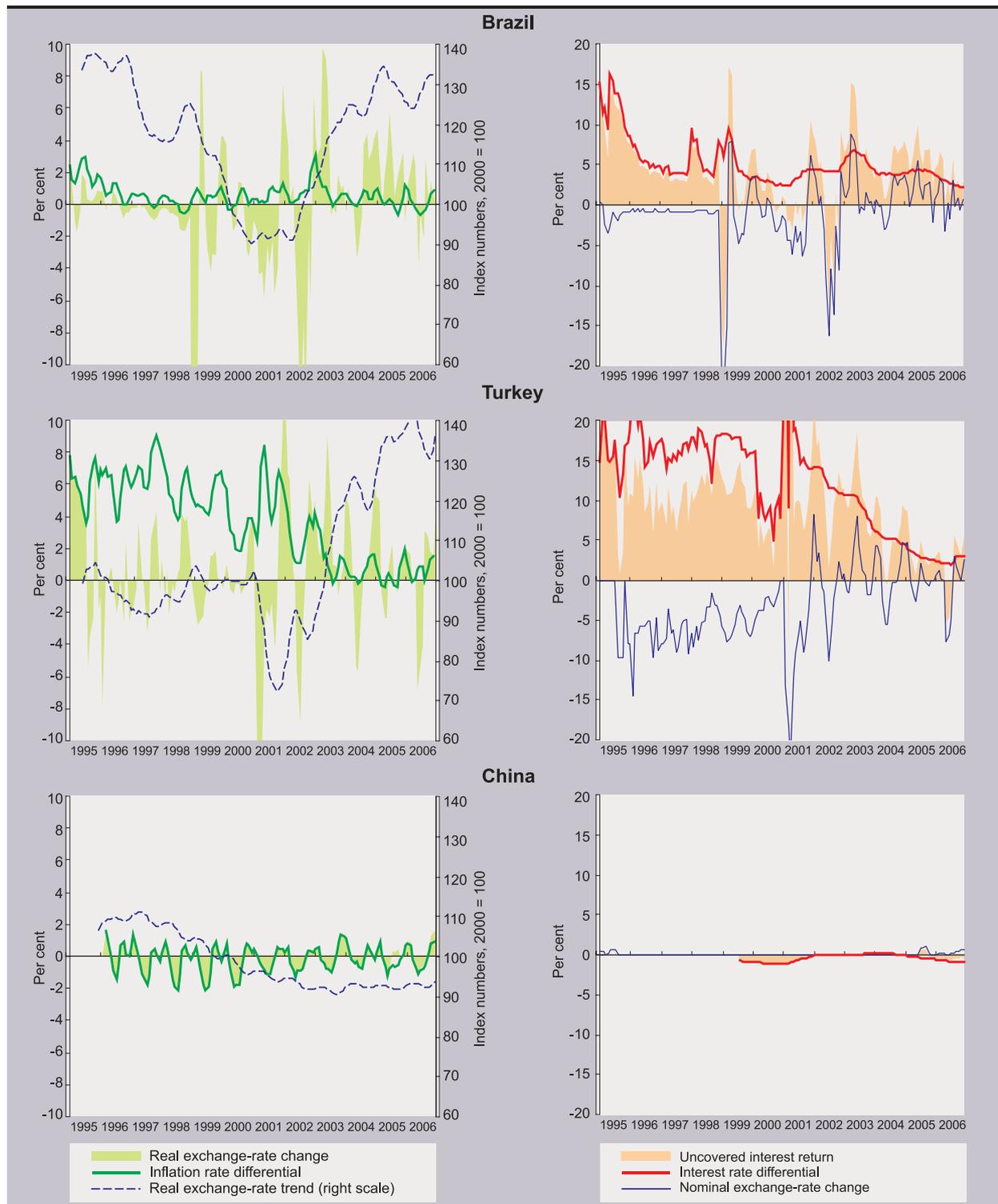
Indeed, the dollar itself has been the target of “yen carry traders” and, to a lesser extent, of traders borrowing in Swiss francs, at least in the past couple of years. But the uncovered interest rate return potentials of yen and Swiss francs to the dollar have been low compared to uncovered returns plus real appreciation in a number of developing and transition economies in relation to the dollar.

In figure 1.4 (see also fig. 1.A1 of the statistical annex to this chapter), the short-term speculative potentials defined as above (right charts) are shown together with the inflation differential and the real exchange rate dynamics (left charts). In the charts on the left, the green line represents the inflation rate differential between the selected economy and the United States, while the shaded area is the change in the real exchange rate, that is, the sum of the inflation rate differential and the change in the nominal exchange rate vis-à-vis the dollar (blue line in the right charts). An index of the real exchange rate is plotted on the left panel (blue dashes) and measured on the right vertical axis.⁶ Using the dollar as a reference for comparison between the countries’ trends and the rest of the world, it is possible to estimate the potentials of yen-funded and Swiss franc-funded carry trade by combining the latter figures with figure 1.3.

The examples of Brazil, Turkey and China show how alternative exchange-rate regimes and their differing monetary policies generate vary-

Figure 1.4

UNCOVERED INTEREST RETURNS, EXCHANGE-RATE CHANGES, INFLATION AND INTEREST RATE DIFFERENTIALS, SELECTED COUNTRIES, 1995–2006



Source: UNCTAD secretariat calculations, based on IMF, *International Financial Statistics* database; and national sources.

Note: A positive change in the exchange rate indicates an appreciation of the currency concerned. Real exchange-rate trend is a 6-month moving average. For an explanation of differentials, see text.

ing degrees of speculative opportunities for the international capital markets; they also show how much real appreciation (with a loss of overall competitiveness for a nation) can result from speculation that is driven by interest rate differentials. Pre-crisis Brazil was characterized by an overvalued real exchange rate, large interest rate differentials (aimed at maintaining capital inflows in a condition of financial fragility) and unsustainable costs for the real economy. Despite the slight real depreciation of the Brazilian real due to a crawling peg exchange rate, the 1999 crisis forced a large nominal depreciation and led to an interest rate hike. The post-crisis change in the monetary regime included official floating of the exchange rate and implementation of an inflation-targeting monetary policy (Barbosa, 2006). Despite relatively high inflation rates (compared to international trends), there has been a tendency in Brazil towards nominal and real appreciation since late 2002, induced by short-term capital inflows. In 2006, the real exchange rate had nearly returned to its 1996 level. Large interest rate differentials aimed at curbing inflation offered considerable potential gains for short-term speculation; indeed, they were comparable in size to those of the pre-1999 monetary regime.

Turkey provides an example of frequent changes in the monetary regime, resulting in large and volatile nominal exchange-rate changes and significant real appreciation (mostly induced by large inflation rate differentials), and consistently associated with large uncovered returns on short-term capital (generated by the large interest rate differentials). Financial turbulence struck the country in 1999 and culminated in November 2000. Despite considerable financial assistance by the International Monetary Fund (IMF) since December 1999 and substantial inflows of portfolio capital, the financial situation once again became unsustainable in February 2001. GDP contracted by 5 per cent in 1999, grew by 7 per cent in 2000 and ended up with a fall of 7.4 per cent in 2001, displaying an extreme kind of boom and bust. The central bank officially gave up control of the exchange rate and, since November 2002, the post-crisis IMF stabilization programme has been officially based on two pillars of financial restraint: a primary surplus target for fiscal deficits and an inflation-targeting framework for monetary policy. However, this again has resulted in a strong

tendency towards real appreciation and large uncovered interest returns. Only recently has the country managed to significantly reduce the interest rate differential, which fell below 3 per cent between July 2005 and March 2006. But with a very high real exchange rate and widening current-account deficits, the value of the currency fell at the end of 2006, preceded by significant capital outflows. Turkey's frequent boom-bust cycles are clearly driven by the effects of potential and actual short-term capital flows (Telli, Voyvoda and Yeldan, 2007).

By contrast, China's exchange rate, capital market and monetary regimes have been extremely stable over a long period of time. A strictly pegged nominal exchange rate, low inflation and low interest rates have led to expectations of stability by investors in fixed capital, and have not attracted this kind of short-term capital speculators. In particular, due to low nominal and real interest rates, short-term returns have been nil or negative, and have discouraged speculative capital flows of the carry trade type. A slight and consistent tendency towards real depreciation vis-à-vis the dollar has only recently levelled off following some inflationary pressures between 2003 and 2004 and the authorities' decision to allow a moderate nominal appreciation in 2005 and 2006.

In the past, in many cases managed depreciation or pegging of exchange rates, associated with large interest rate and inflation rate differentials, have led to real appreciation and the loss of competitiveness, and have offered opportunities for speculation. This occurred to a large extent in pre-crisis Brazil, Thailand, the Republic of Korea and the Russian Federation in the 1990s.

Unfortunately, the regime switch to floating and inflation targeting improved the situation only in those countries that were able to consistently reduce their interest rate differential against the United States. In many other cases, despite slightly lower inflation and interest rate differentials, the tendency towards real appreciation continued unabated. Moreover, the opportunities for international speculation, though subject to larger exchange-rate risk, have not faded; instead, they remain a major source of instability and risk. Short-term interest rates, as the main instrument to combat inflation, have generated new opportunities for large-scale

speculation on the currency market. The real costs for the economies will be very high if the restrictive effects of chronic real appreciation add to high real interest rates and penalize non-subsidized domestic capital formation.

3. Changing opportunities for speculation in emerging market economies

Carry trade, as any other form of speculation on international interest rate differentials that is not covered in the forward currency market, involves a currency risk. Speculative capital flows typically respond to short-term current and expected monetary variables, such as the interest rate, the exchange rate, liquidity and risk. A floating exchange regime supposedly increases the risk and discourages such operations, while a fixed exchange regime provides a (partial) guarantee of exchange stability, and therefore encourages speculation. However, specific experience of carry trade in officially floating currencies does not confirm this hypothesis. Indeed, floating currencies under various monetary policy regimes, rather than being immune to speculative operations actually stimulate them if the amounts available to investors are big enough to drive the market in a certain direction.

Integrating risk into the analysis implies fundamental difficulties in assessing the attraction of speculative capital flows and their effect on the real exchange rate. One difficulty is related to the definition and measurement of expectations and of perceived risk, because they are very sensitive to arbitrary behavioural assumptions. For the sake of simplicity, we look again at the ex-post uncovered interest rate returns, and take the associated currency volatility as a measure of risk, to figure out what, on average, could be the gains from speculation, bearing in mind that expectations can be strongly adaptive under fairly predictable environments. This implies that even a floating exchange-rate regime can provide a stable and comfortable environment for speculators as long as exchange rates do not systematically offset interest rate margins and the exchange-rate movements can be influenced by the herd behaviour of speculators.

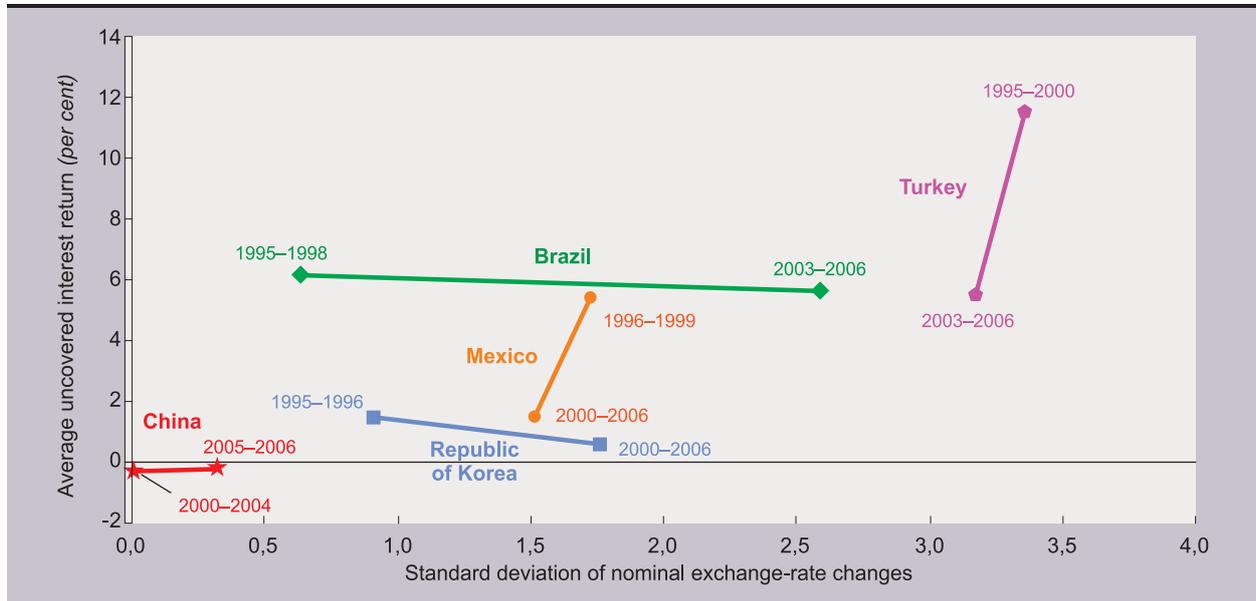
This raises the question of how to come to grips with a central tenet of macroeconomic analysis – the assertion that there are always strong stabilizing forces on the capital market which will tend to quickly remove any arbitrage gain and lead to uncovered interest parity (UIP).⁷ Traditional macroeconomic analysis would assume that currency volatility tends to reduce any form of speculation. However, even allowing for a certain degree of risk aversion on the part of speculators (meaning that for identical expected returns they will choose the assets with a smaller risk), exchange-rate volatility does not discourage portfolio and currency speculation. Clearly, the average return in many countries more than compensates for a risk of depreciation, in particular if the herd behaviour of speculators moves large sums that can influence the market values in their favour. The appeal of large returns is sufficient to generate them.

Figure 1.5 gives an idea of the possible relationship between risk and returns for some pre- and post-crisis periods for selected emerging market economies. The average quarterly returns created by the exploitation of interest rate differentials (vertical axis) are plotted against the volatility of the nominal exchange rate (horizontal axis). The two points for each country compare the situation before and after crisis episodes (i.e. periods of exceptional volatility and change). Large gains entailing relatively low risk were possible in the 1990s in the case of Brazil and Mexico before their respective crises. Turkey, on the other hand, offered spectacular returns in both periods, but these were associated with rather high risk. The Republic of Korea provided much smaller but more stable returns, while China attracted no capital inflows.

The more recent periods display higher risk in the case of Brazil and the Republic of Korea, but still very high returns in Brazil. In Turkey and Mexico, the uncovered return decreases, but the risk is more or less unchanged. Both countries and Brazil remained attractive places for international speculators even after a regime change to floating and lower interest rates. In general, there has been either an increase in risk, as in Brazil and the Republic of Korea, due to a switch to a floating exchange rate, or a fall in the return, as in Mexico and Turkey, due to a reduction in the in-

Figure 1.5

**AVERAGE UNCOVERED INTEREST RETURN AND CURRENCY VOLATILITY,
SELECTED COUNTRIES AND PERIODS**



Source: UNCTAD secretariat calculations, based on IMF, *International Financial Statistics* database; and national sources.

Note: The uncovered returns are the averages of the quarterly returns for the selected periods.

terest rate differentials after the change in the monetary regime. Turkey, Brazil and Mexico, given the combination of return and risk, remained subject to the same kind of speculation before and after changes in their monetary regime.

4. Speculative capital flows and real effects

Large returns on uncovered interest rate speculation as well as large real returns for domestic financial investors penalize international competitiveness and capital formation through high real exchange rates and real interest rates. Figure 1.6 shows the UIR (vertical axis) and real exchange rate appreciation (RERA, horizontal axis) for some developed and emerging markets. As UIR is the sum of the interest rate differential and the nominal appreciation, and RERA is the sum of the inflation differential and the nominal appreciation, their difference is the real interest rate differential between the observed economy

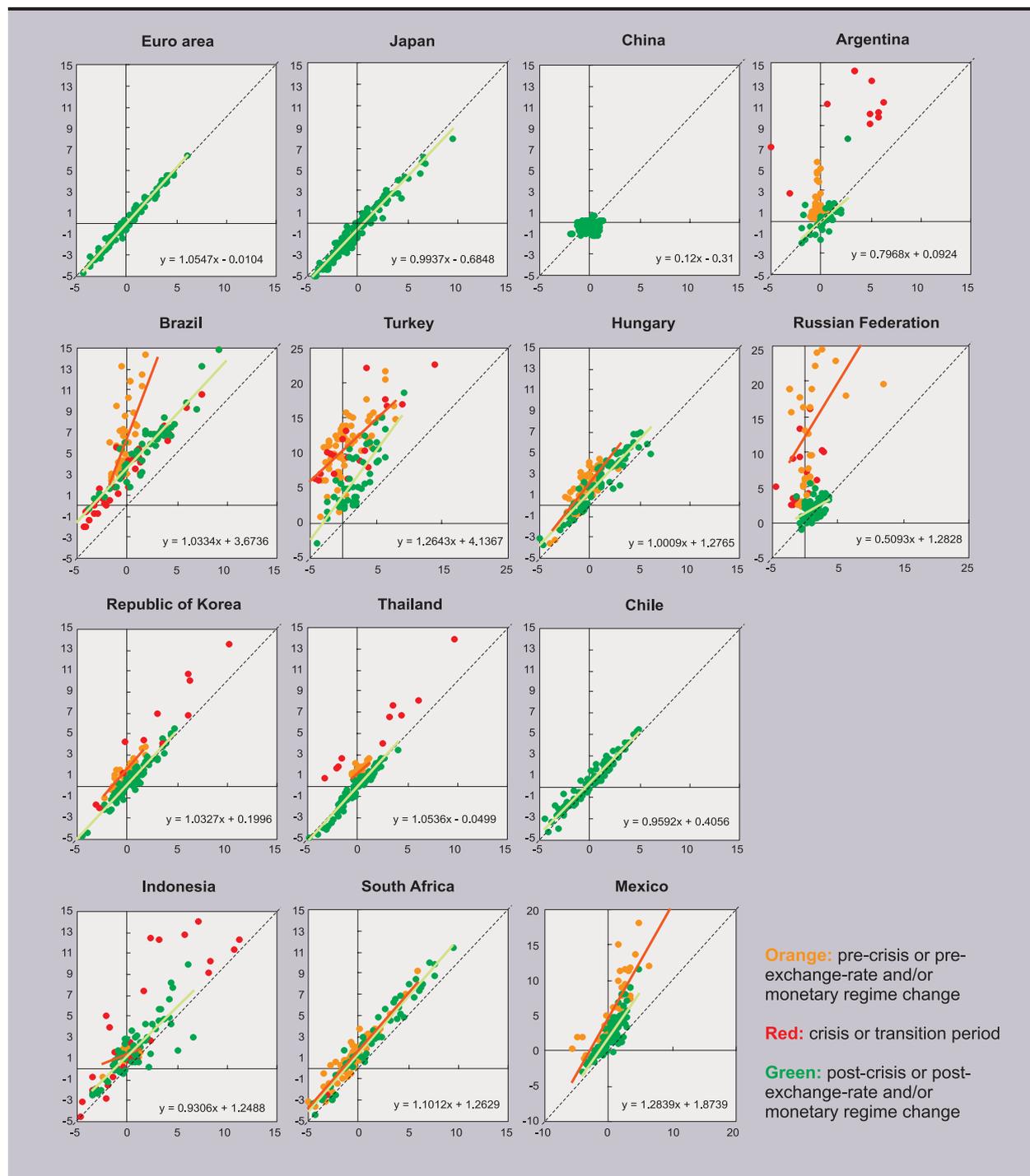
and the United States. It is an indication of the relative cost of capital formation (i.e. the cost to start a business or to extend existing businesses by investment in fixed capital in the country concerned). In the figure, the difference to the United States is the vertical distance of any observation point from the bisecting line (the line with dashes in each chart). The further above the bisecting line the scatter points are, the higher the cost of capital compared to the United States.

The observation points in this figure (each representing a three-month investment) are grouped into a pre-crisis or pre-regime change period (orange colour), a crisis and transitional period (red) and a post-crisis or post-regime-change period (green colour). A tendency of the points to gather around a clear trend line denotes a strong and stable relationship between interest rate differentials, nominal exchange rate variations and inflation differentials. The dispersion of the points along the trend line and the length of the dispersion indicate the degree of volatility of the exchange rate and/or inflation and of the interest

Figure 1.6

REAL EXCHANGE-RATE CHANGES AND UNCOVERED INTEREST RETURNS IN SELECTED ECONOMIES, 1995–2006

(Per cent)



Source: UNCTAD secretariat calculations, based on IMF, *International Financial Statistics* database; and national sources.

Note: For an explanation of how the real appreciation and the uncovered interest return are calculated, see text. Some quarterly observations are not included due to scale limitations. Vertical scale: uncovered interest return (per cent). Horizontal scale: real appreciation vis-à-vis the dollar (per cent). A positive change in the exchange rate indicates an appreciation of the currency concerned.

rate differentials. The interception of this trend line with the vertical axis at a positive value indicates a higher interest rate than in the United States. The slope of the trend line gives a measure of the association between interest rate differentials, inflation rate differentials and nominal appreciation. A trend line with a slope coefficient (the coefficient of x) close to 1 may represent an exchange and monetary policy of minimal intervention in the currency market and a close relationship between the interest rate and the inflation rate (see box 1.1 for a more detailed interpretation of these coefficients).

For most of the economies that experienced a change in their monetary regime, with or without a crisis, their trend line shifted downwards with a reduction of the interest rate differential but not necessarily with a reduction in volatility of the exchange rate, inflation rate and interest rate. Economies that lie close to the bisecting line enjoyed low interest rate differentials and displayed a close association of interest rate and inflation rate differentials. This applies to Chile, Japan and the euro area, and to the post-crisis Republic of Korea and Thailand. Exchange-rate changes have been significant, particularly for the first three economies, and have been the main source of changes in both the real exchange rate and uncovered returns.

For example, Japan and the euro area show a clear tendency to move parallel to the bisecting line, which implies that the exchange rate has not been a concern for the monetary authorities; they have preferred to use nominal (and real) interest rates to control inflation or (deflation). This has induced large swings in the uncovered returns and real appreciation rates. But in the case of the euro area, they have largely offset each other, while in the case of Japan, the observations are concentrated around a low real interest rate, which has invited speculation that has driven the yen down.

For Thailand and the Republic of Korea, after their crises, the change in their monetary regimes from soft peg to float was accompanied by considerable exchange-rate volatility, but with a tendency towards real appreciation. Larger volatility in Indonesia, on the other hand, went hand in hand with even larger appreciation and no significant reduc-

tion in interest rates. Again, China displays its own distinctive pattern of negative real interest rates and a fixed exchange rate, which, given a high degree of stability and the very low cost of capital, has been favourable to the creation of fixed capital through investment.

Brazil, Hungary, Mexico, South Africa and Turkey have recently adopted an inflation-targeting monetary regime that typically requires a free float of the currency and control of inflation rates through interest rates. Although the post-crisis regime marked deep structural changes for Brazil, Hungary, Mexico and Turkey, with a clear shift towards a lowering of interest rates and inflation rate differentials, the level of interest rates is still very high, volatility is large, and the tendency towards real appreciation and a deterioration in overall competitiveness persists for Brazil, Hungary, South Africa and Turkey. Their high real interest rate, consistently larger than the United States benchmark, constrains capital accumulation and may generate inflationary pressures by reducing capacity growth in the longer run.

5. National policies to prevent speculation

For small open economies, and developing countries in particular, a stable and prospering external sector is crucial. That is why the exchange rate is the most important single price in these economies, as it dominates overall competitiveness and has a strong impact on the national price level. Recent studies have found that a “competitive and stable” real exchange rate is a key economic policy tool for developing countries because it enables a persistent pattern of export expansion and investment growth based on a profit–investment nexus (*TDRs 2004* and *2006*; Rodrik, 1995) allowing to take advantage of favourable fundamentals, externalities and proper institutions (Eichengreen, 2007). The challenge for national policies is to combine the control of inflation rates, which has taken centre stage in many developing countries, with international competitiveness and low exchange-rate variability in a world of free and volatile short-term capital flows.

Box 1.1**UNCOVERED INTEREST PARITY**

A fundamental tenet of our theoretical conventional wisdom and a building block of standard macroeconomic models is the uncovered interest parity (UIP), a condition that relates capital and currency market equilibrium to interest rate differentials and expected exchange rate changes. Capital inflows and outflows would find equilibrium if the incentive to buy a currency and invest abroad, driven by an interest rate spread, is completely offset by the potential loss of the currency value, that is, if the positive interest rate spread is compensated by an expected devaluation of the exchanged currency. This implies that assets denominated in a different currency should have the same return so that *no extra profit* can be made by exchanging them. On the other hand, it also implies that it should not be profitable to short-sell or borrow in a currency and lend uncovered in another. The uncovered interest parity condition is therefore an equilibrium condition that rules out excess demand in the international market. Coupled with the assumption that expectations are formed in a fully rational way (market participants use *efficiently all the information* available), it becomes a manifestation of the market efficiency hypothesis that states that any security price (exchange rate included) reflect all available information, and that no unexploited extra profit is possible.

The literature on the validity of parity has been extensive and has strongly rejected the joint assumptions of UIP and of exchange rate expectations on the basis of “perfect rationality”. Attempts to solve the rational-expectation UIP puzzle either by adding a time varying risk premium, or by assuming a transitional learning period, or by adding “noisy traders”, have delivered theoretically and empirically controversial results.

The carry trade phenomenon, as well as many other profitable speculative activities, not only clearly violate the parity condition, but also give additional support to its related “forward-premium puzzle” (Burnside, Eichenbaum and Rebelo, 2007). The evidence that currencies at a forward premium tend to depreciate while currencies at a forward discount tend to appreciate implies that positive interest rate differentials are systematically associated with appreciation. The parity can preserve its theoretical relevance for analysing the possible market equilibrium configurations by avoiding any strict assumptions on expectation formation and determination of perceived risk.

Real exchange rate and uncovered returns

We define ω , ρ , δ , π , and π^* as the uncovered interest return (UIR), the variation of the real appreciation (RERA), the nominal exchange-rate change, the domestic and foreign inflation rates, respectively, and observe that

$$\rho = \pi - \pi^* + \delta, \text{ and}$$

$$\omega = i - i^* + \delta,$$

As emphasized in *TDR 2004* (chap. IV), large inflation differentials lead to large interest rate spreads, because central banks use the interest rate as the principal instrument to curb inflation via a contraction in credit and demand. But nominal

returns are the focus of carry trade by financial investors. These investors are not concerned with inflation differentials and other fundamentals per se, as long as they do not constitute a threat to the stability of the currency and therefore to their ex-

Box 1.1 (concluded)

that is, the rate of real appreciation is the sum of the inflation differential and the nominal rate of appreciation, while the uncovered interest return is the sum of the interest rate differential and the nominal appreciation.

The real interest rate $r \equiv i - \pi$ is defined as the difference between the nominal interest rate and the rate of inflation. The difference between the uncovered return, ω , and the real appreciation, ρ , is the real interest rate differential $\gamma \equiv r - r^*$, with

$$\omega - \rho = (i - i^*) - (\pi - \pi^*) - \delta + \delta = (i - \pi) - (i^* - \pi^*) = r - r^*.$$

We note the real interest rate differential is equal to the vertical distance of each observation from the bisecting line in the (ρ, ω) space (see figure 1.6).

The relation between points in the (ρ, ω) space can be easily captured by identifying the parameters: α and β obtained by regressing the relation

$$i - i^* + \delta = \beta (\pi - \pi^* + \delta) + \alpha,$$

which implies

$$i - i^* = \beta (\pi - \pi^*) - (1 - \beta) \delta + \alpha$$

with β capturing the comovements of $\pi - \pi^*$, $i - i^*$ and δ , and with α measuring a structural tendency of having higher domestic nominal interest rates.

For values close to $\beta = 1$ and $\alpha = 0$, returns and the real exchange rate move along the bisecting line. Real rates of return are close to those of the United States, while interest rate differentials closely follow inflation differentials. Nominal exchange rate changes can be significant and induce large changes in the real appreciations, ρ , and the returns, ω , but do not have an effect on interest rates and inflation rates.

For values close to $\beta = 1$ and for $\alpha > 0$, returns and real exchange rates move on a 45° line, and similar considerations apply to the relation between the variables; however interest rates tend to be persistently higher than those of the United States.

For values of $\beta > 1$, the real interest rate differential γ is greater the larger the values of ρ and ω .

A nominal appreciation is associated with tightening of monetary conditions (with a coefficient $\beta - 1$, for a given inflation rate differential), a nominal depreciation is associated with larger inflation (with a coefficient equal to $(1 - \beta) / \beta$, for a given interest rate differential), and monetary policy responds to inflation by changing the interest rates (at a rate equal to β , for a given exchange rate). The larger β , the larger is the pass-through of the exchange rate on prices and the smaller is the effect of a nominal depreciation on the real exchange rate, or, reversing causality, the larger is the nominal depreciation required to preserve a competitive real exchange rate. Large interest changes are associated with smaller inflation rate changes.

pected profits. The capital inflows induced by nominal interest rate spreads, coupled with an exchange rate that is perceived as either stable or appreciating, on average, or even depreciating but still allowing for sufficient returns, have huge re-

percussions for the real economy and for current-account imbalances worldwide.

The financial and real systemic effects of portfolio capital inflows vary according to the

specific institutional, structural and even cyclical situation of the recipient economy. Financial development and intermediation, the size of the inherited internal and external debt, the composition of production and of the trade balance affect the capacity to absorb the flows and their impact on relative prices and growth. Nevertheless, the scenarios that characterize emerging market financial fragility and volatility share common features. Under a fixed exchange rate or crawling-peg regime, capital inflows boost reserves, money creation and credit expansion, which may induce consumption growth and inflation and an import surge. Under an officially floating exchange regime, they can induce nominal and real appreciation and increase reserves to the extent that the central bank, openly or implicitly, is willing to contain exchange-rate changes. There may be a time lag in their effects on the real side of the economy but it may be critical. An overvalued exchange rate penalizes exports and reduces competitiveness, and therefore the growth of firms in the traded-goods sector. This in turn adversely affects income and growth in general. Finally, deteriorating economic conditions may make the country the object of a renewed focus on “bad fundamentals”; the exchange rate may sharply devalue and the central bank’s ability to contain inflation may be called into question.

If targeting inflation via interest rates involves serious additional costs by inducing capital inflows, such anti-inflationary strategies have to be weighed against alternatives that might be less tried and tested but may yield significant long run real benefits. These alternatives may be found in the new and heterodox national macroeconomic policies applied with outstanding success in most of Asia (*TDR 2006*, chap. IV, section D). In this approach, monetary policy focuses mainly on the external sector, including the exchange rate. Inflation is controlled by other factors and policies than those controlled by the central bank: typically, well-designed income policies taking into account the existing labour market institutions have played a leading role.

Preventing large gains for foreign investors from short-term arbitrage operations keeps the *actual* rate of appreciation in check and cuts the link between these capital flows and the real exchange rate, thus maintaining a country’s competi-

tiveness. Indeed, some countries have consistently been successful in preventing persistent real appreciation. This may require policies to restrain short-term capital inflows and outflows through regulation as long as the expected profitability from speculation cannot be reduced by a traditional set of policies such as an interest rate reduction. Internal and external debt restructuring may help limit the effect of international speculation by reducing nominal interest rates.

6. Globally coordinated policies to reduce global imbalances

The ongoing carry trade from countries with very low inflation and very low nominal interest rates to countries with higher inflation and higher interest rates, such as Brazil, Hungary or New Zealand, breaks the fundamental link between interest rate differentials and the risk of currency depreciation. If floating exchange rates do not follow the purchasing power rule in the short term and destabilize the external accounts, then international policy should aim at preserving this rule as a policy target. Unhedged borrowing by hedge funds and other speculators more than anything else raises questions about the wisdom of widespread acceptance of floating as the only feasible solution to the problem of the external balance.

That is why the political pressure on China to float its currency may end up producing exactly the opposite of the result expected. As China’s interest rates are still rather low, it is by no means clear that the renminbi will appreciate if China were to give in to the pressure from the United States and float its exchange rate. The renminbi might risk following the examples of the yen and the Swiss franc and be carried to high interest rate locations. If that were to happen, it would depreciate and cause a further increase in China’s competitiveness instead of reducing it. Such an outcome would clearly worsen the global imbalances.

Developing countries in general need flexibility and a sufficient number of instruments to prevent excessive volatility of the whole external sector, which threatens long-term investment and

successful catching up. Evidence does not support the orthodox belief that, with free floating, international financial markets will perform that role by smoothly adjusting exchange rates to their “equilibrium” level, while with fixed exchange rates, product, financial and labour markets will always be flexible enough to smoothly and rapidly adjust to a new equilibrium. In reality, exchange rates under a floating regime have proved to be highly unstable, leading to long spells of misalignment, with grave consequences for the real economic activity of the countries concerned. The experience with hard pegs has not been satisfactory either: the exchange rate could not be corrected in cases of external shocks or misalignment, adjustments were costly in terms of lost output, and the real sectors of the domestic economy bore the brunt.

Given this experience with rigidly fixed and freely floating exchange rates, “intermediate” regimes have become the preferred option in most developing countries with open capital markets; they provide more room for manoeuvre when there is instability in international financial markets, and enable adjustment of the real exchange rate to a level more in line with a country’s development strategy. None of the “corner solutions” offer these possibilities. Developing countries that are not members of a regional monetary arrangement that could deal with the vagaries of the global financial markets thus have to resort to controls of short-term capital flows or adopt a strategy of undervaluation and unilateral fixing (*TDR 2004*).

To prevent manipulation of the exchange rate, wage rates, taxes or subsidies in the bid for global market shares, and to deter the financial markets from driving the competitive positions of

nations in the wrong direction, a new code of conduct is needed that would regulate the overall competitiveness of nations. Such a code of conduct, as part of the global governance system, would have to balance the advantages of one country against the disadvantages of other, directly or indirectly, affected countries. For example, changes in the nominal exchange rate that deviate from the fundamentals (such as inflation differentials) affect international trade in exactly the same way as do changes in tariffs and export subsidies. Consequently, such real exchange-rate changes have to be subject to multilateral oversight and negotiations. Reasons for the deviation from the fundamentals, and the necessary size of the correction, have to be identified by an international institution and enforced by a multilateral body. Such rules could help protect all trading parties against unjustified overall losses or gains from competitiveness, and developing countries could systematically avoid falling into the trap of overvaluation that has been one of the major impediments to prosperity.

A long-term solution for the international financial system has to start with the recognition that the idea of a multilateral monetary system is as compelling as the idea of a multilateral trading system. As with multilateral trade rules, a well-designed global financial system has to create equal conditions for all parties involved and should help prevent unfair competition. Indeed, the reasons for which the IMF was founded more than 60 years ago are still largely valid. Avoiding competitive depreciations and other monetary distortions that have negative effects on the functioning of the international trading system is more important in today’s highly interdependent world than at any other time in history. ■

Notes

- 1 If measured at purchasing power parity (PPP) exchange rates, the estimated GDP growth for 2007 is 4.9 per cent compared to 5.3 per cent in 2006. The reason for this discrepancy is that the share in global GDP of rapidly growing developing countries (such as China and India) is much higher when measured in terms of PPP than at market exchange rates.
- 2 In Africa, UNCTAD and the ECOWAS Bank for Investment and Development have pooled efforts to promote the financing of biofuels and jatropha plantations. Under this regional initiative, a fund is to be set up to promote investment in the biofuels supply chain, including for financing research and development, as well as capacity-building (UNCTAD, 2007c).
- 3 REER is a comprehensive measure of the competitiveness of an economy with respect to its trading partners. It is calculated as the average of bilateral real exchange rates weighted by annual values of trade.
- 4 The role of the real exchange rate in the international adjustment mechanism is regaining an attention from the international financial institutions (see IMF, 2007), yet the policy prescriptions are still depending on the diverging views on the sources of the real exchange rate misalignments and the ability of market forces to provide the required adjustment of the balances. The recent world experience tends to reject the case for an effective “market-led” adjustment or the belief that any single economy could independently find its correction measures.
- 5 In *TDR 2006*, it was noted that some interpretations of this situation, mostly by those blaming it on an excess of world savings relative to world investment demand, appear to be inconsistent not only with policy intuition and common sense but also with actual experience. Indeed, in terms of accounting, global imbalances correspond to a misalignment of national savings with investment, and of national income with domestic expenditure. However, neither the savings-investment nor the income-expenditure gaps can be considered the direct sources of the trade imbalance, and therefore of international real income transfers; rather these are the joint outcomes of income changes and relative price movements, such as shifts in the terms of trade, in the real exchange rate and in relative factor costs.
- 6 To reduce its volatility, induced by monthly nominal exchange-rate fluctuations, we use a 6-month moving average of the real exchange rate, with 2000 as the basis year.
- 7 The UIP states that capital flows find equilibrium when the expected devaluation of a currency compensates for the interest rate differential obtained by investing in that currency. As discussed in box 1.1, the empirical evidence rejects UIP when expectations and risk perception are not formed in a “fully rational way”.

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Statistical annex to chapter I

Figure 1.A1

UNCOVERED INTEREST RETURNS, EXCHANGE-RATE CHANGES, INFLATION AND INTEREST RATE DIFFERENTIALS, SELECTED COUNTRIES, 1995–2006

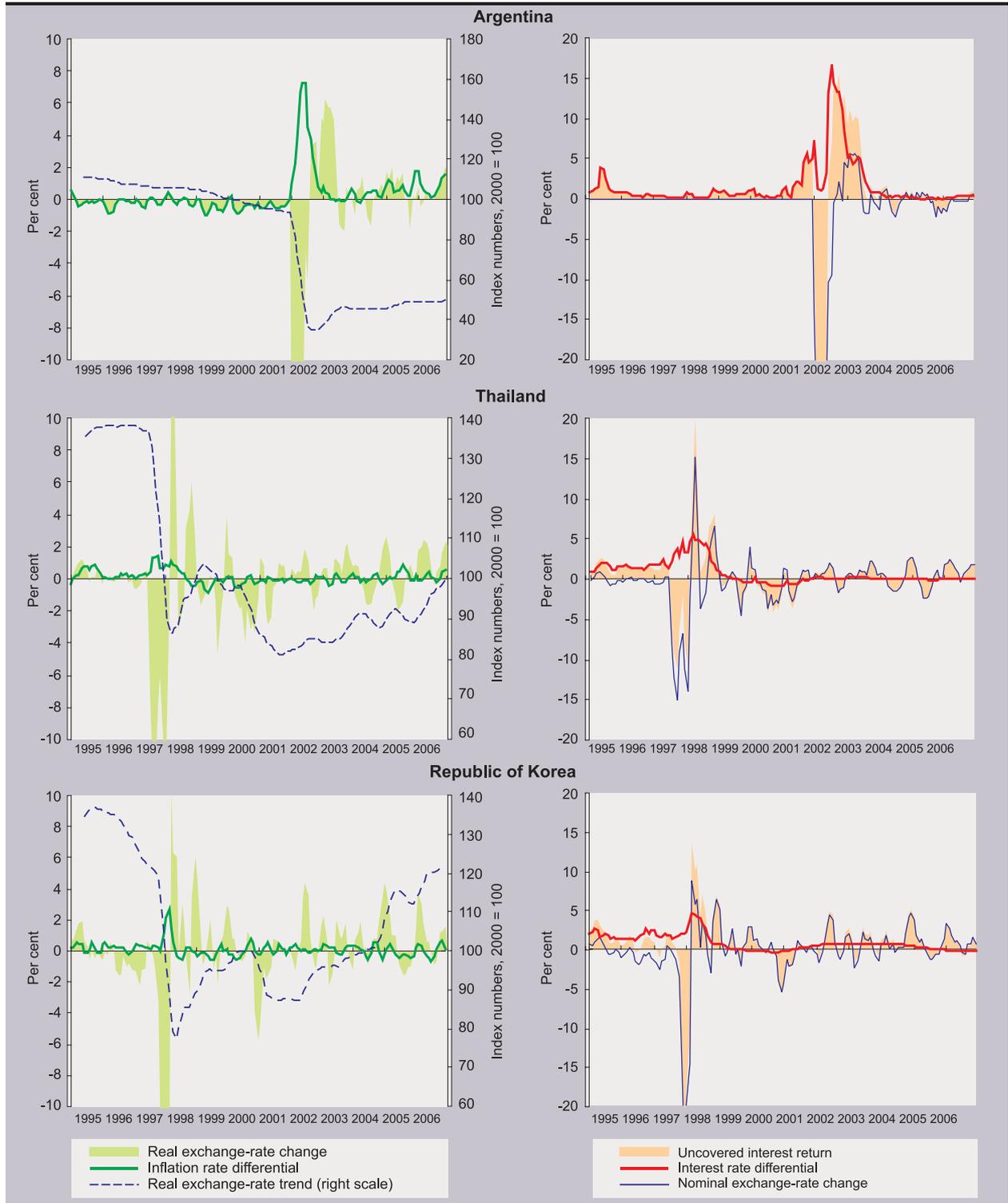
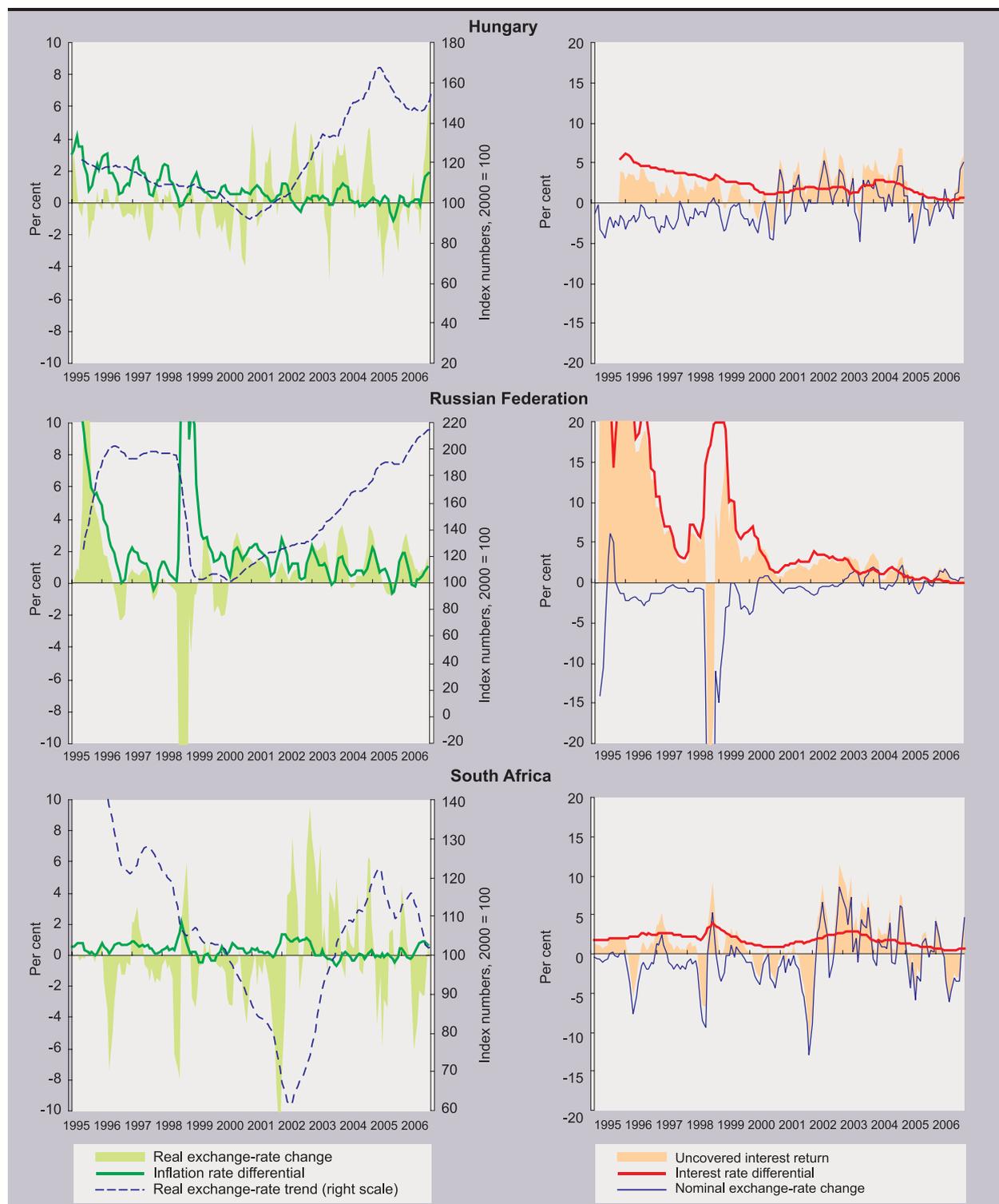


Figure 1.A1 (concluded)

UNCOVERED INTEREST RETURNS, EXCHANGE-RATE CHANGES, INFLATION AND INTEREST RATE DIFFERENTIALS, SELECTED COUNTRIES, 1995–2006



Source: UNCTAD secretariat calculations, based on IMF, *International Financial Statistics* database; and national sources.

Note: A positive change in the exchange rate indicates an appreciation of the currency concerned. Real exchange-rate trend is a 6-month moving average. For an explanation of differentials, see text.

GLOBALIZATION, REGIONALIZATION AND THE DEVELOPMENT CHALLENGE

A. Introduction

Developing countries seek to integrate into the world economy in the expectation that this will help raise productivity levels, improve growth prospects and boost living standards through increased trade, technology and capital flows. Most observers recognize, however, that deriving such benefits from “*external integration*” is contingent on a number of preconditions, including a certain level of local production capacity, skills and technological sophistication, an array of market supporting institutions and good infrastructure. Establishing such conditions is closely tied to a process of “*internal integration*” associated with expanding domestic markets, a shifting pattern of employment away from rural activities, and an increasing industrial division of labour that leads to a dense network of input-output linkages between sectors. Strong institutions are also required to forge the socio-political consensus needed to mobilize and channel resources to productive investment and to manage trade-offs incurred along a dynamic development path, including those arising from increased external integration. Accordingly, *encompassing political structures*, closely associated – but not synonymous – with democratic governance, make up the final component of most development strategies.

Each of these components poses major policy challenges in its own right, and finding the right blend to create a virtuous development circle is a defining challenge of development strategy. However, it may not be possible to push hard on all three fronts simultaneously. In recent years, promoting “deeper integration” has dominated the development agenda, requiring poorer countries to steer economic policies towards integration into world markets and to harmonize their economic institutions, laws and regulations around a narrow but universal set of benchmarks on strong property rights, open markets and good governance. Following this path has been presented as the best (and on some counts the only) way to ensure that the incentives and resources generated by global markets will support and sustain growth and development at the local level.

However, as discussed at some length in previous *Trade and Development Reports (TDRs)*, past experience does not support the claim that strong market-led growth and development will be unleashed simply by eliminating inflation, downsizing the public sector, strengthening property rights and opening up as rapidly as possible to foreign trade and capital.¹ Last year’s *TDR* examined

how the loss of policy space has made it more difficult for developing countries to reduce the income gap with developed countries. It concluded that external influences on national policy targets have become stronger and the trade-offs between internal and external objectives have intensified, in many cases to the detriment of local development goals. It suggested that multilateral structures needed to be more inclusive and flexible if gains from closer integration into the world economy were to be more widely shared. It also suggested that new multilateral disciplines would be necessary, particularly in the area of international finance, if more balanced outcomes were to be achieved. However, multilateral arrangements are not the only option for fashioning collective and coordinated responses to the challenges confronting developing countries in an increasingly interdependent world economy. Indeed, following the failure of the international financial institutions to manage the financial shocks and crises towards the end of the 1990s, and given the slow progress of the Doha Round of multilateral trade negotiations, regional arrangements have assumed a more prominent place on the international development agenda. Accordingly, this *TDR* looks at whether and how regional integration and cooperation might help strengthen the development policy agenda and rebalance international economic governance.

There is a considerable body of literature, mostly deriving from international trade theory, which views this trend with alarm, believing it distracts (or even subtracts) from the optimal gains it deems possible from a truly open global sys-

tem.² From this perspective, regionalization is a “stumbling block”, worse still, it is an “insidious” or even “degenerate” trend.³ However, while regional agreements may have played some role in boosting regional trade and investment at the expense of multilateral transactions, it is far from clear that this is inevitably the case.⁴ Much of the analysis contained in this literature relies on a highly stylized model of the global economy, which downplays (or ignores altogether) some of the more fundamental forces behind regionalization in favour of a singular fixation with the static welfare gains attached to a maximal level of openness and improved allocative efficiency.

Any alternative analysis of regionalization will need to give much greater attention to dynamic economic forces, and to the complementary role of geographical proximity in triggering and sustaining virtuous growth circles. This implies shifting from a singular focus on the formal liberalization of trade flows, to taking more serious account of the challenges involved in other areas of policy as well, particularly those related to infrastructure, industrial development and monetary conditions, as well as those involved in transferring sovereignty from national to international (including regional) bodies. These issues are discussed in section B of this chapter. Section C then considers how dynamic forces linked to internal integration can help trigger regional cooperation arrangements in support of national development strategies, and how regional cooperation can lift some of the constraints on a virtuous growth circle among neighbouring countries.

B. The limitations of conventional thinking

1. *Theoretical approaches to regional integration*

Regionalism is often identified with preferential trading arrangements among neighbouring countries. Such arrangements can assume varying shapes and sizes, the main differences being the extent of preferences granted to members and the degree of policy coordination among them.

Assessments of such arrangements traditionally focused on whether and how their particular mixture of liberalization and discrimination alters economic welfare by creating and diverting trade flows. According to traditional trade theory, economic welfare is maximized under global free trade, which ensures that production is located according to comparative advantage and in line with the most efficient use of global resources. Even countries that are lagging behind in all sectors are deemed to benefit by following this path. Tariffs and other barriers to cross-border exchanges upset this “win-win” logic, distorting the pattern of resource use and reducing the gains from trade. Thus, moving closer to the ideal free trade environment, even if confined to a select group of participants in the trading system, would intuitively seem to represent a welfare-enhancing step. Analyses of customs unions, following the seminal work of Viner (1950), suggest otherwise, given that some trade with non-members might be displaced to higher cost members and tariff revenues can also be lost. Together these could, in theory, outweigh any welfare gains from trade creation.

These analyses of regional trade agreements or customs unions in the context of comparative advantage were not able to prove that they led to an overall improvement in welfare.⁵ The overall effect would depend on the characteristics of member countries, including initial tariff levels and their variation, the existing degree of trade dependence among prospective members, initial cost differences and the degree of complementarity in their production structures. However, the substantial theoretical innovation was that the overall effect might be positive as well as negative, each case requiring a specific assessment.⁶

More recent research, using econometric methods or computable general equilibrium models, has been more empirically grounded. It has focused on measuring the actual changes in trade flows and welfare resulting from specific regional arrangements. According to one influential group of trade economists, there has been a persistent tendency to underestimate the costs of such arrangements, particularly when administrative constraints (such as anti-dumping and rules of origin) are added to the panoply of protectionist measures adopted by them.⁷ But the majority of empirical studies have tended to report small effects on both members and non-members, with net trade creation the more likely outcome, and generally positive – albeit small – overall welfare gains.⁸

The more puzzling issue for conventional trade economists is why, given that in most cases their overall impact appears to be rather small, regional agreements have proliferated in recent years, even as multilateral trade liberalization has

been advancing. Explanations have turned to “political economy”. According to the trade diversion school, regional arrangements have become a vehicle for rent-seeking by well-organized groups, in opposition to the wider interests of the disorganized majority, leading to a world of increased transaction costs and growing protectionism akin, on some assessments, to the situation in the 1930s (Bhagwati, Greenaway and Panagariya, 1998). From this perspective, regionalization has generated a “spaghetti bowl” of intertwining agreements, which clog up the workings of the trading system and pose a threat to a truly free trade order.

A more positive interpretation is offered by those who see in market-driven globalization a much “deeper” process of integration, involving harmonization across a broad range of policies, laws and institutions, and providing dynamic gains associated with access to larger markets, increased FDI flows, technological spillovers and a general heightening of competitive pressures (Lawrence, 1993; Schiff and Winters, 2003). From this perspective, regional arrangements can provide “building blocks” for a global free trade order, especially when they strengthen support for market-friendly reforms and improve the local business climate, particularly its attractiveness for transnational corporations (TNCs). Without denying a lead role for multilateral trade liberalization, the politics of exclusion and frustration (at being sidelined in larger multilateral forums) lends support, particularly among smaller countries, for regional arrangements. Moreover, as support builds, it can trigger a kind of “domino effect” whereby the establishment of one regional arrangement can tip the political balance elsewhere towards pro-integrationist forces, thus reinforcing efforts to join existing arrangements or to form parallel arrangements with other excluded nations. This should cause trade barriers among members to fall (like dominoes) quite independently of multilateral negotiations (Baldwin, 2004).

According to some observers, this domino effect will build support for a fully open world

economy only if the agreements bring together members from the North and the South (Schiff and Winters, 2003). Others believe that goal can best be served by a multiplicity of regional agreements of all shapes and sizes (Ethier, 1998). What unites these with the more sceptical voices is their in-

sistence on judging regional arrangements against a benchmark derived from standard trade theory, where fully open borders to goods, services and FDI are the *sine qua non* of successful development.

There are long-standing doubts about whether these explanations do full justice to the trade and development dynamics associated with regionalization, just as there are doubts about their claim to an unambiguous link between trade

openness and economic growth more generally. These doubts stem in large part from a close examination of the structure and dynamics of modern industrial economies. In the discussions on post-war European integration, prominence was given to the dynamic gains associated with economies of scale and increased intra-industry trade (Grubel, 1977: 595–601); and the search for such gains was even more apparent in the role of regionalization in helping developing countries shift their production and trade towards manufactures (ECLAC, 1949; Mikesell, 1963). A comprehensive assessment of the gains is all but excluded by conventional trade models due to their underlying assumptions. The presence of such factors as increasing returns, technological learning, endogenous factor creation and imperfect information contradict the conditions of general equilibrium while giving rise to divergent social and private costs and rents as well as coordination failures, which provide a rationale for State intervention.⁹

Attempts within conventional models to link regional trade arrangements to such dynamic forces report large welfare gains: up to 10 per cent of GNP (Brown, 1992; Nielsen, 2003); but these often require ad hoc assumptions about strong trade-productivity links and large spillovers from FDI. The presence of dynamic gains means that

It is often believed that regional arrangements can provide “building blocks” for a global free trade order, especially when they strengthen support for market-friendly reforms and improve the local business climate, particularly its attractiveness for TNCs.

no core propositions – including those associated with comparative advantage – can be embraced without strong qualifications. It also casts serious doubts on the standard benchmarking approach to policies adopted in much of the discussion on regional dynamics.¹⁰

2. *The role of geography, history and politics*

Many economists reject the idea of “natural” trading partners, arising purely from proximity, on traditional efficiency and welfare grounds (Bhagwati, 1993; Krishna, 2003). But it is a fact that most countries trade relatively more with their neighbours than with more distant trading partners (see chap. IV), and there is an unavoidable spatial dimension to any regional arrangement. This takes conventional analysis to unfamiliar territory, given that its underlying assumptions, particularly those of fully employed resources, diminishing returns and perfect competition, allow countries to be modelled as dimensionless points where factors of production are instantly moved without cost. In the real world, where there are increasing returns, external economies and variable transaction costs associated with transportation and tariff barriers, proximity does provide some real economic advantages, such as (transaction) cost savings, availability of specialized inputs (both capital and intermediate goods) and skills, tacit knowledge – which is built up (and disseminated) through repeated interaction – and spillovers of various kinds.¹¹ How far these advantages persist (across time and space) will vary with the particular market or sector involved; but they offer the real possibility for productivity and place to become mutually reinforcing (Rosenthal and Strange, 2004).

Moreover, endowments and technology are not a given, information is far from perfect and production is not at all instantaneous; initial institutional, technological and socio-economic conditions shape economic choices and lock in a

particular growth path. Development along this path is likely to be evolutionary, based on prior acquisition of capital and skills, among others, and their incremental improvement. At the national level, the influence of historical and geographical forces on this process leads to a “home bias”, a well-documented feature of economic relations, which shows that national borders continue to exert a strong hold on the location of economic activity.¹² As those relations extend abroad, there is a strong “neighbourhood bias” as shown, for example, by gravity models (Greenaway and Milner, 2002). On another level, the influence of historical and geographical forces is manifest through the variety and mixture of institutional responses, including by the State. Such institutional diversity, to the extent that it is a reflection of a dynamic economic environment is not inconsistent with growing cross-border exchanges or increasing economic interdependence, but it does serve to segment markets and keep transaction costs high, even when trade barriers are lowered (Petri, 2006: 389).

Political motivations and influences are an integral part of regional cooperation, as witnessed in the majority of existing regional cooperation agreements. From the perspective of conventional trade models, such motivations are inherently suspect, since an ideal policy outcome would be the creation of conditions which ensure that global convergence in both incomes and institutions is driven by market incentives. In reality, in any healthy market economy, economics and politics are in permanent interaction. Market failures provide one point of interaction, and the provision of public goods another. But in addition, in industrial economies, markets are simultaneously involved in both creative and destructive processes. Wealth creating processes simultaneously generate problems of adjustment and inequality, including those associated with rising and declining sectors and regions, which in turn give rise, in the political domain, to demands for reform and political action. These reforms, in their turn, give rise to actions that have economic consequences. Trade-offs and bargaining are, consequently, an integral part of economic decision-making (Hirschman, 1991).

Economics and politics are in permanent interaction. Market failures provide one point of interaction, the provision of public goods another.

There is no industrialized country in which the government has not played a central role in promoting and supporting change (North, 1990; Chang and Rowthorn, 1995). It is therefore not helpful to reduce the policy agenda to a choice between free trade and autarky, or between export-oriented and import-substitution measures or, indeed, between State- and market-led development. This should not be taken to imply that States are unable to fail or that government policies are indispensable for taking advantage of agglomeration economies – the East Asian experience of regional integration clearly shows that this is not the case. Rather, what it implies is that market economies can operate within a wide spectrum of different political and social arrangements,¹³ and that when these economies are compared over time, there is considerable evolution in those arrangements. It suggests on the one hand that what works in one period may fail in another, and, on the other hand, that successful economies are those that have been able to adapt their institutions and behavioural conventions to changing circumstances and evolving political and social preferences. This is true for regional institutional arrangements as much as for national ones. From this perspective, today's successful economies are, above all, characterized by "adaptive efficiency": the capacity to develop institutions that offer a stable framework for economic activity, but at the same time are flexible enough to provide the maximum leeway for policy choices, at any given time and in any given situation, in response to specific challenges (North, 1993). In a globalizing economy,

where countries individually have reduced options for national economic policy-making and where the multilateral institutional framework is insufficient or lacks a strong development dimension, the creation of regional institutions may very well be a pragmatic response, and its success would extend the principle of "adaptive efficiency" to cross-border relations.

From this perspective, regional cooperation among developing countries involves a good deal more than the search for common ground on external policies; it also involves the provision of regional public goods and a reconfiguration of policy space. Preferential rule-making, special financing facilities, fiscal transfers, the relocation of industry and labour mobility are just some of the mechanisms on which consensus will have to be found as aspects of national sovereignty are transferred to some form of regional institutional arrangement. At the same time, new political challenges involving the unequal influence of members, and in particular the ability of stronger members to bypass collective agreements, will have to be dealt with. This would mean that regional arrangements, as much as those of national State formation, will have to develop acceptable levels of competence, legitimacy and trust, which is likely to take time. The European experience suggests that regional cooperation is unlikely to follow some established blueprint, that it takes considerable time to evolve, and that the steady build-up of institutional capacity is a critical dimension of success (Wyplosz, 2006: 133).

When developing countries individually have reduced options for national economic policy-making, regional institutions may offer a way of extending the "adaptive efficiency" principle to cross-border relations.

C. Regionalization and policy cooperation

1. *Industrialization and the integration challenge*

The same regions that dominate world trade also dominate world industry: North America, the EU and East Asia together account for almost 80 per cent of world trade in manufactured goods, with about half consisting of trade within each region, and representing more than 80 per cent of world manufacturing value added (table 2.1). This share, despite the onset of deindustrialization in many of the developed countries, has not changed much over the past two decades.

Historical experience, including that of East Asian development, confirms the importance of a broad domestic industrial base for sustained growth and development, given its potential for raising the levels of productivity, employment and incomes. That potential derives, on the supply side, from a predisposition to scale economies, specialization, technological change and learning, and the complementarity of investment decisions; and on the demand side, from favourable price and income elasticities.¹⁴ Successive rounds of increasing productivity growth, rising demand and increasing returns to scale fuel a virtuous growth circle of expanding output, employment and consumption. But industrial activity is also important because it contributes to a dynamic environment in which rent-

seeking through innovation can help strengthen the links between profits and capital formation, which is a critical nexus in establishing a cumulative growth process. As the market grows, and as technological progress lowers the costs of coordination, new opportunities for product differentiation emerge, especially in specialized intermediate and capital goods sectors, but also through a growing variety of consumer and producer goods.¹⁵ This process, whereby firms also divest existing functions to new specialized firms, implies increased market transactions across more and more firms in the same sector. All this adds greatly to the linkage constellation behind successful growth dynamics (Hirschman, 1989).

The linkages created by a progressively sophisticated industrial division of labour are unlikely to be contained within a national economy.

Industrial differentiation broadens the scope for expanding intra-industry trade; but while the potential for expanding such trade is considerable, its direction is unpredictable (Krugman and Obstfeld, 1997: 139).¹⁶ However, from a certain stage of development onwards, it will grow fastest among countries with similar economic structures and technological capabilities. Domestic firms that cross various thresholds in terms of size, productivity performance and technological know-how tend increasingly to trade abroad, giving rise to an interactive and cumulative process between in-

Developing countries that are at early stages of industrial development can benefit less from regional integration than those with a more diversified production structure.

Table 2.1

MANUFACTURING VALUE ADDED, TOTAL TRADE AND TRADE IN MANUFACTURES, EU-15, NAFTA AND EAST ASIA, 1991–2005				
<i>(Per cent)</i>				
	1991	1995	2000	2005
Share in world manufacturing value added				
EU-15	29.8	27.6	23.6	27.6 ^a
NAFTA	24.9	24.9	30.5	25.4
East Asia ^b	25.3	29.5	29.4	29.7
Total	80.0	82.1	83.5	82.7
Share of total trade in world trade				
EU-15	43.2	39.4	35.6	35.2
NAFTA	17.9	18.0	22.3	17.8
East Asia ^b	16.6	18.3	18.1	19.1
Total	77.7	75.8	75.9	72.2
Share of region's manufactured trade in world manufactured trade				
EU-15 ^c	..	39.9	36.0	36.4
NAFTA	..	19.1	24.0	18.8
East Asia ^b	..	20.5	20.4	22.2
Total	..	79.5	80.4	77.4
Share of intraregional trade in manufactures in world trade in manufactures				
EU-15 ^c	..	24.9	21.2	21.2
NAFTA	..	7.9	11.1	7.8
East Asia ^b	..	8.0	8.2	10.3
Total	..	40.7	40.5	39.3

Source: UNCTAD secretariat calculations, based on *UNCTAD Handbook of Statistics* database.

a Data for the United Kingdom in 2005 corresponds to 2004 due to lack of data.

b Comprises China, Hong-Kong (China), Japan, the Republic of Korea and Taiwan Province of China.

c Trade between Belgium and Luxembourg is not reported in the data until 2002.

ternal and external integration.¹⁷ Exports enlarge the size of the market and thus allow scale economies to be further exploited, while a growing outward orientation also exposes firms to new products and processes, and to new sources of

competition. These considerations apply to outward orientation generally, but for many developing countries that are at an early stage of industrial development, a regional orientation involving countries at a similar level of development may be considered a more viable option, because the initial foreign competition may be less difficult to handle and the technological gap vis-à-vis competitors from more advanced countries outside the region may be easier to close.

Manufacturing firms may also seek further advantages by establishing affiliates abroad. The resulting FDI flows are predominantly undertaken by large and technologically sophisticated firms seeking to consolidate rents from their specific assets, with some combination of cost differentials, large market size and technological sophistication determining location. Moreover, as more and more countries advance, there will be considerable FDI flows in the same sector (i.e. through intra-industry flows) (Hymer, 1976; Rowthorn, 1992; Driffield and Love, 2005). Some overseas production will involve the replication of entire plants abroad, but there can also be vertical disintegration of industries geographically through FDI, as individual activities are detached and relocated. The degree of fragmentation will vary from sector to sector, depending on the extent to which new technologies help reduce coordination costs, and on the linkage intensity of particular activities (Venables, 2006: 19). The resulting “international production networks” that emerge from this process will likely accelerate the cross-border movement of component parts and semi-finished products, which in many cases will take the form of intra-firm trade (*TDR 2002*, Part Two, chap. III).

Where neighbouring countries undergo a similar process of industrial take-off and internal integration, cross-border market and production linkages and firm level linkages can be expected to intensify. Once such external linkages reach a certain level of intensity, there will be pressure from producers within the region to lower or remove the various barriers to intraregional trade, including bureaucratic red tape, conflicting legal restrictions and administrative procedures, as well as demands for better transport and communications infrastructure. These various demands are likely to be accompanied by the creation of institutions for closer cooperation.¹⁸ Industrial differentiation –

to use intra-industry trade for scale economies or for production sharing – depends on the decision of firms, not of governments; but national industrial policies can support this process, and coordination and harmonization of such policies at the regional level can help make national industrial policies more effective.

Thus, formal regional cooperation is not a precondition for de facto integration. The former can follow the latter, as in Western Europe and in East Asia. In general there will be a dynamic interaction between the two, provided that economic structures evolve in a way that allows the creation of cross-border linkages, and that cooperation takes the form that is the most appropriate for addressing the most binding constraints on fuller integration. At first, such cooperation will tend to focus on technical issues (trade barriers, standards and the like), but as regional production and trade systems become more integrated, the need for coordination and collaboration will grow, most likely causing the regional policy framework to expand in order to manage the growing level of interdependence.

But it must also be recognized that there are limits to the developmental effects that can be obtained from regional integration among developing countries, depending on the stage of development of the members of the group. Those countries and regions that have not yet developed a sizeable capital goods sector have to earn the necessary foreign exchange to enable them to import capital and intermediate goods for which they rely on the industrialized or industrially more advanced developing countries. Similarly, developing countries whose exports are highly concentrated in a small number of primary commodities will generally find limited markets in their own region and in other developing countries. For both reasons, developing countries that are still dependent on primary production or are at an early stage of industrial development can benefit less from regional integration with partners at similar stages of development than those that have already achieved a more diversified production structure.

2. Bridging gaps and battling constraints

The bulk of international inequality is explained by differences between regions rather than differences within them. Moreover, evidence of regional convergence from Europe and Asia suggests that economic performance is in part defined by similar initial conditions, capabilities, attitudes and social institutions among neighbouring countries. The previous section has suggested that key to realizing economic potential in poorer countries

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(and reducing inequality) is the emergence of an industrial division of labour at the national and regional levels. But this process can be hindered by the imperfect flow of information and high transaction costs. Bridging these gaps and overcoming the constraints on industrial take-off, diversification and sustained catch-up growth, require public policies that take a long-term view

for mobilizing and directing resources, rather than aiming at maximizing short-term returns on capital. The resulting intertwining of economics and politics requires a capable government bureaucracy with access to a wide array of policy measures, including industrial policies, and the room to tailor these to local conditions (Kozul-Wright and Rayment, 2007).

The formation of such State actors is a complicated process, but where it does happen, it gives neighbouring countries the possibility to benefit from the demonstration effects of watching economic success close at hand, as well as to react to the threat of falling behind. However, as the processes behind internal and external integration become more and more interdependent, and the effectiveness of some domestic policy responses diminish, the more difficult it becomes for governments to achieve national objectives on their own. This loss of policy space is, as noted earlier, likely to give rise to various forms of cooperative arrangements among countries.

The multilateral institutions that emerged after the Second World War sought to organize

such cooperation around the provision of “international public goods” and the design of rules, norms and regulations that would prevent “beggar-thy-neighbour” policy responses of the kind that proved so destructive in the 1930s (*TDR 2004*, Part Two, chap. III). Such cooperation extended to the pace and direction of trade liberalization, the provision of liquidity finance during balance-of-payments crises, long-term development finance, and surveillance and monitoring of financial and monetary policies. The institutions responsible for managing this cooperation were not designed with the problems of developing countries in mind. However, the flexibilities that helped strike a balance between policy space and collective action among the more developed countries were extended to a growing developing-country membership, often in the form of exceptions to the existing rules. But given that the gaps between developing countries and those higher up the development ladder have been much wider than those facing earlier generations of industrializers, the need for international cooperation to help overcome the constraints on catch-up growth has been more pronounced.

However, even among the developed countries, it was recognized that shared challenges might best be handled through a more limited membership whose priorities were similar and between whom trust, consensus and a sense of common purpose (and ownership of actions) could be more easily established. This was apparent from the outset of post-war international cooperation, when financial support for European reconstruction was made the stated aim of the fledgling World Bank. It was even more apparent when the Marshall Plan assumed a key role in reconstruction from the late 1940s, and brought with it the creation of the first institutions for regional economic cooperation in Western Europe (see also chap. VI, sect. C). The regional dimension was retained as the World Bank moved into development finance proper,

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In order to meet common challenges, pooling regional resources might be a sensible way forward.

including with the creation of (its sister) regional development banks, beginning with the Inter-American Development Bank in 1959, and later, the (more independent) sub-regional banks, particularly in Latin America and the Caribbean (Culpepper, 2006: 54–61). These institutions were, however, more concerned with generating a sufficient flow of resources to member countries that faced tight constraints on international borrowing than with fostering greater economic integration per se.¹⁹ Regional trade arrangements – particularly once their legitimacy was

confirmed in rules under the General Agreement on Tariffs and Trade (GATT) – offered more tangible opportunities for a collective response to the constraints on catch-up growth.²⁰

Access to a larger market, as a means to achieving scale economies and diversifying production has been a long-standing rationale for regional arrangements among developing countries. It helps avoid some of the dangers of excessive protection that might accompany import substitution policies in individual countries, while channelling the more creative impulses of markets through a healthier type of industrialization.²¹ However, in developing countries with low levels of income and large rural populations, more is involved than choosing the right trade policy. Effective regional integration may accelerate growth and structural change and facilitate convergence among countries, but there is little reason to assume that trade liberalization alone will achieve this. Nevertheless, the chances that liberalization of trade and finance may have a positive net impact in this regard tend to be greater when it occurs among countries in the same geographical region – owing to advantages arising from proximity – and at similar stages of development, owing to the greater probability of finding a “level playing field” (see chap. IV).

The development literature has identified other constraints and gaps that can disrupt cumu-

lative growth dynamics, and where national development policy might conceivably be complemented through regional cooperation. In its simplest form, the latter may focus on lowering technical and bureaucratic barriers to trade and on ensuring the dissemination of a critical amount of information on trading possibilities. The provision of physical infrastructure, particularly in the form of transport and communication networks, can be as if not more important than the reduction of tariff barriers and formal quantitative restrictions. Energy and water resource management remains a binding constraint on the industrialization process in many developing countries, and effective cooperation in these areas can help create productive capacities that expand their trade and growth potential. Environmental and health challenges, as well as other aspects of human development, can also constitute potential obstacles to growth prospects. Because tackling these challenges will often involve high sunk costs, long gestation periods and free-rider problems, there is a danger that neither market forces nor national government projects will provide the ideal solution; an alternative could be combined or common action by countries at the regional level.

Similar considerations extend to other constraints on the growth process, such as those associated with technological development, where most developing countries rely heavily on accessing technology from abroad and absorbing it within local production systems. Meeting this challenge will require appropriately crafted national policies and institutions. Still, national innovation systems may well be devised with an explicit regional dimension involving collaborative research, training schemes and information gathering, and may extend to complex institutional issues such as those relating to the design of intellectual property regimes. They may also be better tackled by harmonizing rules and laws on a regional basis and by pooling resources to ensure their more effective management in light of local needs and conditions. While in many respects the European experience may not be an appropriate model for regional cooperation among developing countries, which has to be conceived under

very different historical, economic and political circumstances, it suggests that in order to meet common challenges, such as accelerating diversification into dynamic sectors, upgrading the industrial structure and raising agricultural productivity, pooling regional resources might be a sensible way forward (see chap. VI, section C).

Additionally, regional financial cooperation can be a response to constraints on the industrialization process resulting from the need for external financing, in particular when access to international capital markets is costly, unreliable or non-existent. Regional payment arrangements can help solve this problem. Moreover, to the extent that neighbouring countries share other financing constraints, such cooperation could be extended, whether through help with mobilizing resources, through support for domestic financial development, or through countering external shocks. Finally, while market

liberalization focuses on prices at the micro-economic level, stable trade and financial relations, combined with investment-friendly macroeconomic conditions, require getting the macroeconomic prices (i.e. interest and exchange rates) right. In the absence of an appropriate multilateral framework, regional coordination and cooperation and developing an appropriate macroeconomic policy regime, including, in particular, monetary and exchange-rate management, is likely to be a viable second-best solution (for a more detailed discussion, see chap. V).

In the absence of an appropriate multilateral framework, regional cooperation is likely to be a viable second-best solution.

3. Global financial governance and regional cooperation

Financial and monetary cooperation among developing countries has received particular attention since the 1990s, partly because the development prospects of many countries have been shaped more by the globalization of finance than by global trade expansion. Financial crises in emerging market economies illustrated the risks stemming from the volatility of private interna-

tional capital flows, especially speculative short-term flows, and the detrimental effects the vagaries of international financial markets can have on international trade and sustained growth. They also exhibited the lack of an effective international regulatory framework to deal with those risks. As a result, dissatisfaction with the IMF, as the institution in charge of preventing and managing financial crises, spread (Stiglitz, 1998; IMF-IEO 2003, IMF-IEO, 2004; and *TDR 2006*: 138–140). The IMF had not only wrongly assessed the situation preceding the crises, but also the terms and conditions of its financial support were increasingly perceived as counterproductive, as they implied fiscal and monetary tightening that actually aggravated the economic recessions. Moreover, dissatisfaction among governments grew, because conditionality went beyond what could be justified by the need to safeguard the resources of the IMF, thereby unduly violating the sovereignty of the borrowing countries, and because it did not differentiate between country-specific circumstances.

This experience has given further impetus to regional financial arrangements as an alternative way of handling financial shocks and their aftermath (see chap. V). The growing volume of intra-regional trade and investment flows, and the synchronization of business cycles within regions, as well as the growing detachment of developing-country regional blocs from the more advanced regional blocs has further encouraged this trend. Some observers believe that such arrangements point to new trends in regional cooperation, in which regional financial institutions assume a much more active role in fashioning the integration process through macroeconomic coordination, exchange-rate management and monetary union (Dieter and Higgott, 2002).

The institutional and political hindrances to moving forward remain considerable, and progress in implementing concrete measures has been tentative. Fully-fledged regional systems of financial surveillance and policy coordination or exchange-rate coordination are yet to be elaborated.²² But

with only limited reforms in the governance of global finance, building collective defence mechanisms against external shocks and strengthening macroeconomic coordination at the regional level remain firmly on the agenda of many developing countries. In all geographical regions, considerable attention has focused on how to achieve exchange-rate stability in order to prevent crises, and how to bolster trade and competitiveness, including the use of regional currencies.

The fact that countries differ in terms of their creditworthiness and the types of flows they are likely to attract raises the possibility of different types of financial cooperation, coordination and surveillance emerging at the regional level. For countries with no or only limited access to com-

mercial markets, official development assistance (ODA) remains key to financing development. There is an ongoing debate on how best to manage aid flows; but there is a consensus that the current mix of bilateral and multilateral arrangements causes aid to be too politicized, too unpredictable, too conditional and too diffused to act as a catalyst for growth and domestic resource mobilization (UNDP, 2005; UNCTAD, 2006). A stronger

regional dimension in coordinating and channeling aid flows may be one way to improve the effectiveness of the aid system. The backbone of such a system is already in place in most regions, with the regional economic commissions of the United Nations, the regional development banks and various ad hoc political arrangements that provide a combination of leadership, financing and technical assistance. Using these institutions to support infrastructure development and other public goods that straddle borders is already recognized as a way to strengthen regional cooperation in Africa and other poor regions (IEG, 2007). Regional bodies are also likely to be better placed to channel aid through budgetary support, increasingly seen as a more effective way of disbursing aid flows. They could also provide more effective monitoring of its use, and budget management assistance tailored to local circumstances. Moreover, these bodies are well placed to enable the

Strengthened regional cooperation does not exclude other forms of international or South-South cooperation. Indeed, proximity matters for some areas of cooperation, but may be irrelevant for others.

sharing of experiences and to launch ministerial dialogues in a number of policy areas, including the problem of capital flight, financial sector development and harmonization of regulatory, accounting and reporting systems (Aryeetey, 2006).

Foreign direct investment is an important source of external finance for many developing countries, and the inflow of choice for many policymakers. However, there is a need to carefully weigh the costs as well as the benefits of FDI, and regional dialogue and cooperation may be helpful in this regard. Regional coordination and monitoring might provide useful support for fashioning the kind of policy space needed to effectively manage FDI, particularly in those dynamic sectors where there is a danger of overinvestment and destructive export competitiveness. Uncoordinated policies aimed at attracting FDI can result in a race to the bottom as governments cut regulations and offer generous tax incentives in a wasteful bidding war to attract TNCs, rather than striking a fine balance between costs and benefits (*TDR 2005*, chap. III, sect. F). Regional arrangements may be a sensible way to manage some of these issues by forging consensus and establishing a common bargaining position on areas such as the harmonization of corporate codes, contract enforcement, tax incentives and avoidance, and transfer pricing.

Strengthened regional cooperation does not exclude other forms of international or South-South cooperation. Indeed, proximity matters for some areas of cooperation, but may be irrelevant for others. An example of the need for South-South cooperation, where proximity does not necessarily matter, is for coordinated policies to attract

FDI, especially in the primary sector, where countries in different regions but with similar natural resource endowments frequently “compete” for external capital. On the other hand, regional cooperation is more important for coordinating policies related to attracting FDI to the manufacturing or service sectors, where there is a greater likelihood for competing interests among countries in the same region to lead to a race to the bottom by offering too many incentives to potential foreign investors. Regional cooperation in this area would be easier if other elements of regional cooperation are already in place. Indeed, in some cases it is precisely because certain institutional arrangements for cooperation and coordination already exist that regional cooperation in other areas becomes possible.

To the extent that global institutions are perceived as having failed to sufficiently promote developing-country interests, regional financial arrangements are seen as offering the kind of sensitivity to and familiarity with local conditions that is needed to reconcile differing national needs and objectives with international opportunities and constraints. As European experience shows, progressively more sophisticated regional monetary and financial arrangements can lead to greater stability in a region. In the absence of any major reform of the international financial system, they can also contribute to greater coherence in global economic governance. The fact that a number of developing countries have accumulated considerable foreign-exchange reserves offers new options for monetary and financial cooperation among developing countries in general, and at the regional level in particular. ■

Notes

- 1 See *TDR 1997, 2003 and 2006*; ILO, 2003; UN/DESA, 2006.
- 2 See, for example, the papers in Frankel, 1998.
- 3 See respectively Bhagwati, 1991; McLaren, 2002; and Oman, 1997: 28.
- 4 The notion of “open regionalism” has, for example, challenged the idea of a simple conflict between regionalism and multilateralism (Kirkpatrick, 1994).
- 5 See, in particular, Meade (1955), Lipsey (1960), Krauss (1972), Pomfret (1986) and Kowalczyk (1992) for reviews of the literature.
- 6 These traditional analyses considered mainly customs unions, and therefore might not fully apply to free trade agreements (FTAs), where each member country can choose its own external tariff. Prevailing prices in these markets have long been considered at a level equal to world prices plus domestic tariffs. But, as in an FTA, member countries are free to sell their products in any other member country, which can lead to the phenomenon of trade deflection: producers in low-tariff members will have the incentive to sell their products in high-tariff members, where prices are also higher, leaving the domestic market to be served by imports from the rest of the world.
- 7 See Bhagwati, 1991; Panagariya, 1999; Yeats, 1996; and Wei and Frankel, 1996.
- 8 See Robinson and Thierfelder (1999) and Nielsen (2003) for extended reviews of the literature. The – limited – empirical work undertaken in the 1950s and 1960s also reached this conclusion, mainly from an examination of the European experience (see Sodersten, 1970: 439–40).
- 9 It has sometimes been suggested that these factors were initially sidelined because of the lack of rigorous modelling capability, which has only recently been corrected. Taylor (1994) has rightly pointed out that their being sidelined owes less to the rigour with which they were originally presented than to political factors associated with the rise of the neo-liberal policy agenda, along with a certain narrow-mindedness of the economics profession.
- 10 Because the global economy is a long way from the level playing field idealized by conventional models, tracing the welfare effects of any policy change is very much a hit-and-miss exercise. Consequently, the predictions often attached to liberalization packages, whether at a multilateral, regional or bilateral level, should be treated with a healthy degree of scepticism. On the empirical and methodological problems with general equilibrium models, see Taylor and von Arnim, 2007; Polaski, 2006; and Ackerman, 2005.
- 11 It should be noted, though, that transaction costs are not a direct function of distance. For certain countries, especially in Africa, transaction costs are lower in economic exchanges with countries in the other regions than with neighbouring countries (see also chap. VI, sect. C).
- 12 The bias has been well documented (see, for example, McCallum, 1995; Rose and Engel, 2002; Anderson and van Wincoop, 2001).
- 13 Much of the market failure literature is still premised on the idea of a perfectible benchmark, which rarely exists in a world where decision-making takes place in the context of uncertainty, and where imperfect modes of organization and governance, and a variety of mixes of them, are the norm (Nelson, 2007).
- 14 The stylized facts, which give a premium to industrial development, are associated with the classical development literature and the work of researchers such as Myrdal, Prebisch, Kaldor, Lewis and Chenery. For a more recent discussion of the role of industrialization in development, see *TDR 2003*, chap. V; UN/DESA, 2006: chap. II; and Rodrik, 2006.
- 15 Young (1928) was among the first to recognize the importance of this process to modern capitalist development.
- 16 It should be recognized that intra-industry trade is not necessarily inconsistent with factor proportions theory, if those proportions vary more within industry groups than between them.

- 17 The relationship between openness and growth is a long-standing source of controversy (see, for example, Agosin and Tussie, 1993; Frankel and Romer, 1999; Rodriguez and Rodrik, 2000; Dollar and Kraay, 2001; and Rodrik, 2000). A review of the debates is also provided by Kozul-Wright and Rayment, 2007. It is worth noting that even for Britain, “all the figures suggest that ... it was the success of British industries that caused exports to grow, not the success of British overseas trade that made industries grow” (Ogilvie, 2000: 123). On the evidence of which kinds of firms export, see Bernard et al., 2007.
- 18 Intra-industry trade in Western Europe was already important in the 1950s, but the drive to keep reducing transaction costs by removing administrative and other obstacles often came from the enterprise sector. This was the case with the 1992 Single Market Programme.
- 19 As Culpepper (2006: 44) notes, this was perhaps less true of the African Development Bank, thanks in part to wider regional political circumstances and the exclusion of non-borrowing industrial country members until 1982.
- 20 For differing assessments of the evolving Latin American experience with regional agreements in the 1950s, see Mikesell, 1961, and Urquidi, 1961.
- 21 This is closely associated with the work of Raul Prebisch, drawing on his Latin American experience.
- 22 For assessments, see Kawai, 2005; Park, 2006; and Sohn, 2007.

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THE “NEW REGIONALISM” AND NORTH-SOUTH TRADE AGREEMENTS

Regional economic cooperation occurs in various forms and degrees, and is in general aimed at increasing cross-border linkages and deepening interpenetration of economic activity for the mutual benefit of economies within a geographic region. A distinction is frequently made between policy-induced integration, which is also called regionalism and involves formal economic cooperation arrangements, and market-driven integration, also termed regionalization, which is spurred by regional growth dynamics, the emergence of international production networks and related flows of FDI. As individual developing countries become more vulnerable and lose national policy autonomy in the process of globalization, regional economic cooperation can also be a defensive response in the hope that a regional partnership will soften the impact of global factors and help them to cope better with globalization. From this perspective, regional institutions could also fill gaps in global economic governance structures.

Formal regional cooperation and effective integration interact with each other: formal cooperation can pave the way for the creation of cross-border input-output linkages, while pressure from producers within the region to lower or re-

move the various barriers to intraregional trade grows as such external linkages intensify. These various demands are likely to be accompanied by the creation of institutions for closer cooperation. The form that such cooperation takes will depend not only on the specific historical, geographical and political circumstances in a region, but also on a fundamental choice of the relative weight given

to market forces and State intervention – a choice that also influences economic policies at the national and global levels. Over the past two and half decades these policies have been based on the belief that market liberalization and opening up to international trade and finance would lead to the best possible factor allocation in general, and raise productivity and accelerate technological

upgrading in developing countries, in particular. This tendency to give priority to market forces in determining factor allocation is reflected in the rapidly increasing number of regional and bilateral free trade agreements (FTAs) or preferential trade agreements (PTAs) since the early 1990s (fig. 3.1).

This chapter first discusses the concept of regionalism and how it has grown rapidly since the beginning of the 1990s, a period during which

The form of regional cooperation depends on the specific circumstances in a region, and on the relative weight given to market forces and State intervention.

the number of developing countries adhering to multilateral agreements negotiated within the framework of the World Trade Organization (WTO) also increased rapidly. As most regional or bilateral FTAs in recent years have been concluded between a developed and a developing partner, section B examines the implications of such agreements from a development perspective and vis-à-vis

WTO agreements. Section C discusses the effects on Mexico's development of the most prominent North-South FTA, the North American Free Trade Agreement (NAFTA) between Canada, Mexico and the United States. Although concluded in a specific geographical context, NAFTA is often perceived as a possible model for other North-South agreements.

A. Regionalism and the proliferation of free trade agreements

The term "regional trade agreement" (RTA)¹, is often used to include PTAs not only between countries belonging to the same geographical region, but also those between countries not geographically contiguous or even nearby.² Moreover, traditionally, RTAs involved only reducing or eliminating barriers to trade, but since the beginning of the 1990s such agreements also involve what has come to be called "deep integration", which includes additional elements of harmonizing national policies in line with a reform agenda that favours greater freedom for market forces and reduces options for government intervention. The fact that regional cooperation extends beyond the reduction of trade barriers is not entirely new, because, as discussed in subsequent chapters of this report, regional cooperation has often covered areas such as monetary and financial cooperation or common projects in energy or industrial policy. What is new, is that many of these agreements make the reduction of trade barriers conditional on partners agreeing to liberalize such additional areas as their FDI re-

gime, government procurement, trade in services and competition policy (Shadlen, 2005a). Also new is that most FTAs and RTAs since the early 1990s have involved countries with much larger differences in per capita income and level of development, and that they have been concluded mainly among countries not belonging to the same geographical region (Burfisher, Robinson and Thierfelder, 2003). These two elements characterize the "new regionalism", a term that is somewhat misleading, since in reality it refers to trade agreements that are mostly bilateral and concluded between countries in different regions.

The trend towards this "new regionalism", as distinct from multilateralism, has grown out of a sense of frustration of some governments at the slow

progress in multilateral trade negotiations, and their perception that FTAs can serve as a vehicle for advancing a far-reaching agenda of economic liberalization and harmonization across a broad range of policies, laws and institutions aimed at promoting the internationalization of investment

The tendency to give priority to market forces is reflected in the rapidly increasing number of free trade agreements concluded since the early 1990s.

and production. In a way, this “new regionalism” bypasses multilateral institutions and arrangements as governments pursue economic objectives and use instruments for which no agreement could be found at the multilateral level. At the same time, it reflects the tendency to perceive globalization as a process whereby access to markets of the North and attracting FDI from developed-country investors is key to successful integration of developing countries into the world economy.

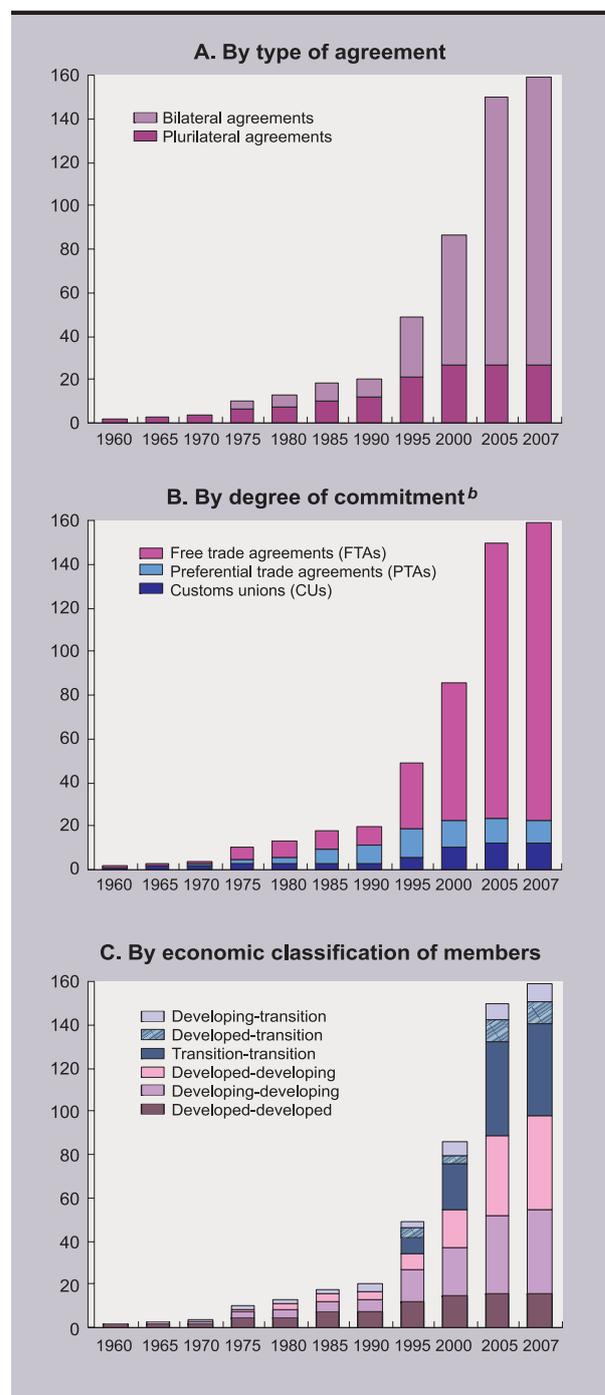
Since the early 1990s, the number of trade agreements has increased rapidly: in 1990, 20 arrangements were notified to the GATT/WTO, increasing to 86 in 2000 and to 159 in 2007.³ Until the 1990s, plurilateral agreements dominated, but subsequent agreements have been mainly bilateral, and most are FTAs rather than customs unions (figs. 3.1A and B). Typically, bilateral FTAs involve lower levels of commitment to economic integration than multilateral customs unions or common markets, and are concluded between countries from different regions and at different levels of development. Indeed, many of the new pacts have been between developing and developed countries, thus increasing the proportion of treaties between them from 14 per cent of the total number of agreements in 1995 to 27 per cent in 2007 (fig. 3.1C).

The WTO report, *The Future of the WTO*, criticized the proliferation of bilateral and regional trade agreements on the grounds that this has made the most-favoured-nation (MFN) principle the exception rather than the rule, and has led to increased discrimination in world trade (WTO, 2004). However, negotiations of such agreements have continued to progress.

There are several reasons for the rapid growth in the number of trade agreements. One has to do with the fragmentation of States in Central and Eastern Europe and the former Soviet Union, and the dissolution of the Council for Mutual Economic Assistance (COMECON).⁴ Previous trade linkages between national or subnational economies that needed few trade arrangements or no arrangement at all – when the parties were constituents of a single State – were replaced by dozens of new agreements between them and with other parties, boosting the number of trade agreements involving transition economies (fig. 3.1C).

Figure 3.1

NUMBER OF PLURILATERAL AND BILATERAL TRADE AGREEMENTS, CUMULATIVE, 1960–2007^a



Source: UNCTAD secretariat, based on WTO, 2007.

- a** Data include trade agreements notified to the GATT/WTO at the time they entered into force. Agreements on services and accessions of new members to existing agreements are not included.
- b** Movements from one kind of agreement to another are taken into account.

On the other hand, the accession of 10 new members to the EU led to the abrogation of 65 trade agreements notified to the WTO, as all the previous bilateral arrangements between them and the EU, as well as agreements with third parties that already had preferential agreements with the EU, came to an end (Crawford and Fiorentino, 2005: 8). As shown by these examples, there is not necessarily a positive correlation between the number of trade agreements and the intensity of economic integration: a single RTA between several countries may result in stronger trade and economic integration than a large number of bilateral agreements between them.

Another reason, of greater economic and developmental relevance, is the trend by major developed countries to seek bilateral or regional agreements with developing countries in parallel with ongoing multilateral trade negotiations. The United States has been the most energetic in negotiating FTAs, particularly with developing countries. In 1994 it concluded NAFTA with Canada and Mexico, and in the same year an initiative was launched to achieve a continental FTA “from Alaska to Tierra del Fuego”, renewing the Pan-American trade integration project the United States had unsuccessfully championed in the late nineteenth century. However, negotiations reached deadlock on issues such as agricultural subsidies, and the initiative faced growing opposition in several Latin American countries. As a result, and in view of the slow progress in the Doha Round of multilateral trade negotiations, the United States has turned increasingly towards bilateral FTAs. Its position was clearly stated by Zoellick (2003), the United States Trade Representative at the time: “We will not passively accept a veto over America’s drive to open markets. We want to encourage reformers who favor free trade. If others do not want to move forward, the United States will move ahead with those who do.” Under the Trade Act of 2002 that re-established the “fast-track” trade

Certain issues on which no agreement could be found in multilateral trade negotiations have become elements of bilateral FTAs.

FTAs tend to reduce the policy space of developing countries to influence the manner of their integration into the global economy.

authority, the United States Government completed bilateral FTAs with 11 other developing countries, in addition to NAFTA, and 5 more agreements are under congressional consideration.⁵ It also intends to enter into bilateral trade agreements with all 10 members of ASEAN (McMahon, 2007).⁶

The EU has also signed various forms of bilateral FTAs with developing countries and economies in transition, although not as many as the United States. Economic partnership agreements (EPAs) are under negotiation with the African, Caribbean and Pacific (ACP) group of countries, aimed at strengthening economic and political relations with many former colonies, and negotiations between the EU and several North African and West Asian countries are intended to culminate in a Euro-Mediterranean Free Trade Area by 2010.⁷ It also has preferential Partnership and Cooperation Agreements with South-East European countries, as well as traditional MFN agreements with the Russian Federation and other members of the Commonwealth of Independent States (CIS). In the case of some Eastern European countries, such agreements have prepared the ground for accession to the EU. Apart from agreements with the group of ACP States, the EU has additional bilateral preferential agreements with seven developing economies,⁸ and is in negotiations for FTAs with the Southern Common Market (MERCOSUR) and a number of Asian countries.

More recently, Japan has been involved in bilateral trade negotiations with several countries in the Asia-Pacific region, probably in response to competitive pressures resulting from trade agreements they have signed with other developed countries. It has already agreed FTAs with Singapore and Mexico, and is engaged in talks with members of ASEAN and the Republic of Korea. Other developed and developing economies, such as the European Free Trade Association (EFTA), Australia, Chile, China, Mexico, Singapore and

Turkey, have also pursued a strategy of entering into bilateral PTAs with countries from very diverse regions, thereby adding to the proliferation of such agreements.

The present trends towards trade integration, particularly the proliferation of FTAs and PTAs between countries at different levels of development, introduce fundamental changes to the pre-

vious paradigm of regional agreements. These earlier agreements were among countries at relatively similar levels of development, which, *inter alia*, sought the establishment of economic and political areas that would maintain or enlarge the policy space of their participants vis-à-vis the rest of the world. The following section examines the specific implications of North-South bilateral agreements in greater detail.

B. Issues relating to North-South free trade agreements, the WTO and policy space

A developing country may be tempted to conclude a bilateral agreement with a developed-country partner because it expects some concessions that are not granted to other countries, particularly better market access for its products. But there are also several potential disadvantages, to a large extent resulting from the fact that certain issues on which developing countries could not agree in multilateral trade negotiations have become elements of bilateral FTAs. These include far-reaching liberalization of foreign investment and government procurement, new rules on certain aspects of competition policy, stricter rules on intellectual property rights, and the incorporation of labour and environmental standards. Moreover, most FTAs oblige developing countries to undertake much broader and deeper liberalization of trade in goods. Some also involve liberalizing services that differs from what is envisaged in the context of WTO agreements and implies greater pressure on developing countries to make liberalization commitments in this area. In addition, while their commitments in the WTO already reduced the policy space that developing countries had at their disposal to influence the manner of their integration into the global economy and the

possibility for developing internationally competitive domestic industries, many of the elements of such FTAs reduce that space even further, in some cases very significantly (*TDR 2006*, chap. V, sect. C). These elements are not considered in standard modelling analyses of the impact of trade liberalization, yet they may have lasting effects on the trade and growth potential of the developing-country partners. Some of the major issues surrounding such agreements are discussed in this section.

1. Reciprocity

Because they involve reciprocal commitments, FTAs between developed and developing countries eliminate the special and differential treatment that may be granted to developing countries in the context of other agreements (Crawford and Fiorentino, 2005; Khor, 2007a). For instance, the Lomé Convention (signed in 1975 and renewed four times until 2000) granted the ACP countries preferential access to the EU market without reci-

procuity. Its successor, the Cotonou Agreement of 2000, extended this non-reciprocal arrangement until the end of 2007, at which time it is to be replaced by EPAs,⁹ which would include FTAs based on the principle of reciprocity (Cotonou Agreement, Article 36;¹⁰ EC, 2007). Thus ACP countries will be required to give full access to substantially all EU exports within a reasonable time (Godfrey, 2006). Another example of a formerly non-reciprocal RTA being converted into a reciprocal one is the Central American Free Trade Agreement (CAFTA) with the United States.¹¹

One important reason why reciprocity is a major principle underlying FTAs and RTAs, is because such agreements have to comply with GATT Art. XXIV (8)(b), which requires that duties and other restrictive regulations of commerce be “eliminated on substantially all the trade between the constituent territories in products originating in such territories” (WTO, 1994: 522–525). However, so far there is no agreement among WTO members on the meaning of “substantially all the trade”, and the issue is under discussion in the context of the Doha Round. Consequently, many agreements exclude from their coverage large and sensitive areas such as agriculture and textiles, which makes it difficult to assess the compatibility of FTAs and RTAs with WTO rules. Recently, in the Doha Round negotiations, there have been proposals to revise or clarify Article XXIV so that it would explicitly allow non-reciprocal relations in FTAs between developed and developing countries.¹²

This is necessary because the reciprocity principle in North-South FTAs places developing countries at a disadvantage vis-à-vis their developed-country partners, as they typically enter into the liberalized trade relationship at a less advanced stage of domestic industrial development, implying lower supply and marketing capacities and less potential for outward foreign investment. In order to comply with the principle of reciprocity, developing countries are forced to cut tariffs from a significantly higher level, especially on industrial products. This makes it difficult for local firms and farmers to compete with imported prod-

ucts, especially when some of these imports remain heavily subsidized by their country of origin, as in the case of agricultural products exported from the EU and the United States. Most importantly, insistence on reciprocity formally contradicts the non-reciprocity principle in Part IV of GATT (Trade and Development)¹³ and Article XIX of GATS.¹⁴

2. Market access for goods and government procurement

Improving access to the markets of partner countries is the key motivation for developing-country governments to sign up to an FTA or RTA. In many cases, this motivation is likely to be reinforced by a fear of marginalization: the perceived risk of losing competitiveness vis-à-vis other developing countries, often neighbours or countries from the same geographical region that might have entered into an FTA with the same main trading partner (Shadlen, 2007). This may have played an important role in driving individual Andean and Central American countries to negotiate separate bilateral agreements with the United States: it appears to have created “an incentive for others to move ahead”¹⁵ and to generate “a dynamic in which countries compete to become fuller members of the trading system and better partners of the United States” (USGAO, 2004).

In the short run, several factors can circumscribe the expected outcome, even at the stage of negotiations on improved market access for sectors that are typically of interest to developing countries. Firstly, in North-South bilateral negotiations, a developing country’s bargaining power is usually weaker. Secondly, even if the developed-country partner were to reduce or withdraw the export subsidies and domestic subsidies on goods produced by the developing-country partner, this may not give the latter an export advantage, because it would also benefit other exporting countries that are not partners in the FTA. Thirdly, the

The elimination of tariffs and subsidies removes a powerful policy instrument for improving a developing country’s supply capacities in the long run.

flexibility in what the developed-country partner can offer is often constrained by its national legislation, such as the United States Bipartisan Trade Promotion Authority Act, or very complex governance and decision-making processes, such as for EU trade and agricultural policy. Moreover, it is often difficult for developed-country negotiators to make offers of increased market opening for imports of agricultural or sensitive industrial products due to threats of a political backlash from lobby groups that are usually better organized than in developing countries. For these reasons, the major developed countries have not accepted a reduction or elimination of agricultural subsidies as a negotiable issue in bilateral agreements.¹⁶ Consequently, developing-country partners to bilateral trade agreements are deprived of perhaps the most important potential source of increased market access in the major developed countries.

Another factor limiting market access in an FTA or RTA is the restrictiveness of rules of origin for goods exported by the developing-country partner, which, in the case of NAFTA, have been found to offset the advantage of a preferential tariff (Anson et al., 2005). Moreover, owing to their limited capacity to penetrate foreign markets, developing-country partners are unable to derive the full benefits of the improved market access opportunities of an FTA, at least in the short and medium term. For instance, most of the ACP countries and the least developed countries (LDCs) have been unable to fully use their preferential access to the EU market. In addition, a number of the products in which the developing countries have a competitive advantage are “sensitive” for the developed country, and therefore likely to be excluded from the preferential treatment accorded by the FTA. Market access hopes may be additionally frustrated by developed countries’ frequent use of non-tariff barriers, such as safety regulations and anti-dumping measures, that hinder imports from developing countries.

The gains for developing countries from improved market access through FTAs are not guaranteed, and may be short-lived, but the loss of policy space is certain.

The possibility of using government procurement as a policy instrument can be substantially eroded by FTAs.

On the other hand, under an FTA, a developing country is also expected to grant improved access to its own market for suppliers of the developed-country partner through the reduction or elimination of tariffs and often also non-tariff barriers. This often results in a surge in imports, which frequently leads to a worsening of its trade balance with the developed country. The elimination of tariffs and other trade barriers in almost all categories of goods removes important and powerful instruments of industrial and agricultural policy, which, in addition to protecting its infant industries, are often indispensable for improving the developing country’s supply capacities in the long run – a precondition for maximizing the potential gains from trade liberalization. Thus the gains for developing countries from improved market access are far from guaranteed; whereas they have to give up a large part of the policy space they might otherwise have used to promote the creation of new productive capacities, industrial upgrading and structural change in their economies (see *TDR 2006*, chap. II, sect. G, and chap. V, sect. D and E).

One particular aspect of market access is government procurement, an area covered by the WTO through a plurilateral agreement that is not obligatory, and indeed few developing countries have signed up to it. From 1997 to 2004 discussions were held in the WTO on a possible multilateral agreement on transparency aspects of government procurement, and the topic was included in the Doha Round agenda. Yet many FTAs already include not only transparency of government procurement, but also of market access, and the FTA partners are given national treatment rights to compete for government procurement.

This has serious developmental implications. Many developing countries apply guidelines that favour the granting of projects to local companies and people (for example by reserving some purchases

or projects only for locals, or by allowing the acceptance of local bids that are higher by a certain margin than foreign ones). The scope for using government procurement as an instrument to support weaker or nascent domestic industries is considerable: public investment and other government spending on goods and services can amount to 10 per cent of GDP or more. Variations in government spending for domestically produced goods and services is also a tool of countercyclical macroeconomic policies. Moreover, government practice to source from different local suppliers can also be an actual or potential policy instrument for achieving a better balance in the economic weight of various social groups and communities within a nation.

The possibility of using government procurement as a key policy instrument in line with such domestic policy considerations is substantially eroded by an FTA that requires liberalization in this area. National treatment of foreign bidders can result in the loss of market share of local firms and of foreign exchange. It is true that a bilateral North-South FTA theoretically also gives the developing country's firms better access to the typically much larger procurement market of the developed-country partner. However, in reality, it is unlikely that a net benefit from market access for government procurement will accrue to developing countries, because generally they lack the supply capacity in the types of goods and services to be provided under an average government contract.¹⁷

3. Liberalization of services

The WTO's General Agreement on Trade in Services (GATS) allows each member to choose the extent and rate of its commitments to liberalization of trade in services to suit its conditions. It also contains some development safeguards, and clauses for special and differential treatment.¹⁸ Thus, to some degree, a developing country retains the possibility of experimenting with liberaliza-

tion of services and reversing its decision if the outcome is not beneficial.

Bilateral FTAs or RTAs also involve liberalization of services with regard to cross-border trade in services as well as the establishment of foreign service enterprises and their investments. In contrast to the more development-friendly WTO positive list approach, there is a tendency for developed countries, in particular the United States, to convince developing countries to switch to a negative list approach, which may not be to their advantage.¹⁹ Since their service industries are typically not very advanced, trade negotiators may not be sufficiently aware of all relevant subsectors and

thus not list all those they may wish to exclude from liberalization. There is also a risk that a developing country may not include in the negative list certain service sectors that it may wish to promote domestically at a later date as their strategic role becomes clear only after the negative list has been established. Or negotiators may be unaware of the risks entailed in giving up certain

options for the regulation of services, but will find it difficult to backtrack when circumstances require protection of the domestic economy, as happened during various financial crises (Khor, 2007b).

Service subsectors such as banking and finance, transport and telecommunications, and medical, legal and accounting services, can play a strategic role in economic and social development. This is why many developed countries in the past and some even today as well as developing countries after the end of the colonial period, have promoted domestic and often State ownership of such activities, and restricted foreign participation in such sectors.

Strengthening domestic service sectors as a complement to industrial diversification is important for developing countries, not only because it may help to increase overall productivity through specialization at the firm level, but also because these sectors offer considerable employment opportunities due to their relatively high labour intensity, even at more advanced stages of their

Accelerated liberalization of key service sectors can disrupt or hinder the process of establishing a national strategy for services.

development. Foreign participation in service activities may be useful as a complement to the domestic provision of services, but accelerated and excessive liberalization of key sectors, or even across-the-board liberalization, under legally binding rules of an FTA has the potential to disrupt or hinder the process of establishing a national strategy for services.

4. Investment and investor protection

Liberalization of services is closely related to rules on foreign investment – another highly controversial issue at the WTO. During the Uruguay Round, developed countries sought to include investment rules in the multilateral trade negotiations, but developing countries succeeded in restricting the agreement to trade-related investment measures (TRIMs). Negotiations on investment rules were also part of the Doha agenda agreed in 2001, but following a groundswell of opposition to this at Cancun in 2003, the WTO General Council withdrew investment from the Doha negotiations agenda in July 2004. The opposition of the developing countries to the introduction of a multilateral investment agreement is based on the concern that such an agreement would significantly reduce their options to design specific investment policies geared to their development objectives, including selecting and setting conditions for foreign investment by means of entry requirements, equity structure and performance, for example with regard to technology transfer, and regulating the transfer of funds relating to foreign investment. However, in addition to international investment agreements negotiated at the bilateral, subregional or regional levels,²⁰ most bilateral FTAs between developing countries, on the one hand, and the EU, Japan or the United States, on the other, now include an investment chapter that reduces or prohibits the use of such instruments.

The scope and definition of investment in FTAs are usually very broad. In those involving the United States, they cover greenfield invest-

ment, portfolio investment and credit, as well as assets in the form of intellectual property rights and other tangible or intangible, movable or immovable property and related property rights. In a radical departure from past and current practice in many developing countries, foreign actors investing in any of these assets are granted pre-establishment rights, thus drastically reducing the scope for a host country to decide whether or not to approve a foreign investment or impose conditions for such an approval. Moreover, measures specifically favouring local investors through preferential treatment have to be curbed as these are seen to discriminate against foreign investors, thus violating the principle of national treatment. The investment chapter in most FTAs involving one of the major developed economies and a developing country covers all sectors and adopts a negative list approach, according to which it is assumed that every sector will be totally liberalized unless exceptions are specifically listed.

The combination of the broad definition of investment with the provisions on pre-establishment rights and free transfer of funds has the potential to increase financial instability and to prevent measures that could be taken to reduce such instability or crises. Under these conditions, several of the measures adopted successfully by Malaysia, for example, during the financial crisis of 1997–1999, such as temporary restrictions on outward capital transfers outflows by foreigners in Malaysia, would have been prohibited. Moreover, under FTAs involving the United States, investors who believe their rights have been violated and have suffered a loss can sue the host government in an international arbitration court for compensation for expropriation. The definition of the latter includes “indirect expropriation”, which may include policy measures that affect the present or future revenues of a foreign enterprise.²¹

Although FTAs in general, and the inclusion of investment chapters in particular, are aimed at attracting additional FDI to developing countries, this effect is uncertain. Experience suggests that other factors, such as availability of natural resources and a well-developed infrastructure, a

Most bilateral North-South FTAs reduce options to design development-oriented FDI policies.

sizeable domestic market or strong growth in domestic industries, are as, if not more, important than fully liberalized trade and investment regimes. It is well known that a large proportion of the foreign investment in developing countries occurs as a result of private business strategies, and not because the investors *a priori* share the national development objectives of those countries. Thus, foreign investment can have positive effects for development when it happens to be in line with the national development policy agenda, but it can have negative implications when it does not. Government policy can therefore play an important role in regulating investment so as to derive positive benefits from it, while minimizing or controlling the adverse effects.²²

5. Intellectual property rights

The inclusion of intellectual property rights (IPRs) in North-South bilateral and regional trade agreements has also been viewed critically by many observers.²³ In the context of the WTO, the Agreement on Trade-related Aspects of Intellectual Property Rights (TRIPS) sets minimum standards for compliance by WTO members, but it also contains certain flexibilities for developing countries, for example to counter anti-competitive practices of holders of IPRs, and to pursue social and development objectives. Developing countries have sought clarification on some aspects of that Agreement with the aim of reducing its potential negative effects on key areas of development. For instance the Doha Declaration on TRIPS and Public Health has clarified that, under certain conditions, developing countries can make use of flexibilities such as compulsory licences to offset the monopoly privileges of patent holders.

Similar to other controversial issues in WTO negotiations, IPRs have become an issue in bilateral and regional North-South agreements, with some major developed countries seeking to pur-

sue objectives that go beyond the WTO TRIPS Agreement (*TDR 2006*, chap. V). Thus, many regional and bilateral trade agreements reduce the possibility for governments to set their own criteria for patentability or to use other flexibilities, such as compulsory licensing, as a policy instrument (Maskus, 1997). For example, many recent FTAs involving the United States do not allow governments to issue compulsory licences except during declared states of national emergency, or to prevent anti-competitive practices by the patent holder, or for non-commercial public use. Furthermore, some FTAs tend to extend the term of the patent beyond that contained in the WTO TRIPS Agreement, among other means, by recognizing new patents for “new uses” of an already patented product (World Bank, 2005a: 98–102; Khor, 2007b; Stiglitz, 2006). They also affect the use by developing countries of the flexibilities provided in the WTO TRIPS Agreement relating to patenting of life forms and protection of plant varieties.²⁴

In addition, some FTAs oblige developing countries to introduce stricter copyright legislation, which can have adverse effects on technology transfer or access to information and information technology (IT). For example, recent FTAs involving the United States typically require countries to extend copyright protection to 70 years, compared to 50 years in the TRIPS Agreement.

Thus the developing-country partner in bilateral FTAs can be expected to incur additional costs as a result of IPR obligations that go beyond the already onerous ones

of the WTO TRIPS Agreement, since most patents, copyright and other forms of intellectual property (IP) are mostly owned by foreigners. The costs entailed can take the form of increased royalty and IP licence payments (with a resulting loss of foreign exchange), or higher prices of the protected products; and there can be social costs due to reduced access to medicines and to knowledge, along with an increased threat to farmers’ rights to seeds and other resources.

A developing country may suffer additional costs as a result of bilateral intellectual property right obligations.

6. Competition policy

At first glance, competition policy is taken to mean restricting the power of large corporations, especially transnational corporations (TNCs), to prevent them from dominating the market, to facilitate market entry of newcomers and to ensure a critical number of market participants. However, in the context of negotiations over FTAs involving the United States and the EU, competition is taken as a concept closely linked to market access, giving foreign firms and their products and services the right to free competition vis-à-vis local firms in the markets of developing countries. As noted earlier, free competition in this sense implies that preferences and support given to local firms, and any advantages they enjoy compared to suppliers from the FTA partner country, are to be curtailed or eliminated. However, in many cases this attempt to create a “level playing field” is unlikely to result in greater competition in developing-country markets since, at the outset, TNCs typically enjoy the advantages of larger size, greater financial resources, more advanced technologies, better marketing networks and established brand names. From a development perspective, a genuine competition framework should incite local suppliers to become increasingly capable of competing successfully, starting with the local market, and then, if possible, internationally. Building local capacity to become and then remain competitive requires a long-term horizon, and in many cases temporary protection from the full force of the world market is needed for the time it takes to build local capacity. From this perspective, competition policy should act as a complement to other areas of policy for strategic integration. Allowing support and more favourable treatment to local firms with controlled entry to foreign competitors could enhance – rather than hamper – competition, as the smaller local firms would be given time to develop the capability to better withstand the market power of large foreign companies, which otherwise would monopolize the local market.

A competition framework should enable local suppliers to develop the capacity to become increasingly capable of competing successfully, starting with the local market and then internationally.

FTAs that involve the United States typically require the developing country to establish competition legislation similar to that prevailing in the United States. Development economists have questioned whether the frameworks of competition policy that are in place in the developed countries are appropriate for developing countries.²⁵ These frameworks may hinder the growth of local firms and reduce their ability to compete or survive against large foreign firms, especially in the context of increasing globalization (Correa, 1999; Singh, 2002). By removing assistance to and protection of local companies, competition policy in the FTA would in many cases result not only in the weakening of the competitive position of local companies, but also in less competition.

7. Conclusions

In sum, bilateral North-South FTAs have the potential to provide the developing-country partner with considerable new trading opportunities. However, preferences negotiated by one developing country with a developed partner may quickly be eroded if the same developed country also concludes FTAs with other developing countries. Thus, FTAs can result in some export gains, and possibly increased FDI inflows, but the size and durability of these benefits is highly uncertain, as are the net gains for trade and output growth. This is because the FTA will most likely lead to an increase in imports, with implications for the trade balance and, in some cases, the external debt position. Moreover, if future North-South FTAs are modelled on those that have been negotiated so far, it is likely that they will considerably reduce or fully remove policy options and instruments available to a developing country to pursue its development objectives.

Another consequence of bilateral trade agreements is that they tend to weaken existing or evolving regional common markets that may offer the

potential for considerable long-term gains for developing countries. If countries that are members of the same regional cooperation agreement or customs union conclude different agreements with third countries, or if some conclude such an agreement while others do not, the common external tariff and other rules governing the common market are infringed. A recent example of such an effect is the crisis that was triggered in 2006 in the Andean Community after Colombia and Peru concluded separate bilateral trade agreements with the United States. Trade agreements negotiated by the EU outside the WTO framework may carry a lower risk of such disruptions as these negotiations are not bilateral in the narrow sense, since they are undertaken with regional groups or otherwise defined groups of developing countries, such as the ACP (World Bank, 2005a: 136; Cernat, Onguglo and Ito, 2007). Nevertheless, the African Union's Conference of Trade Ministers in 2006 expressed "profound disappointment" with the EPA negotiations between the EU and African sub-groupings, which in their view did not adequately address development concerns. Specifically, they stressed that these agreements should be "consistent with the objectives and process of economic integration in Africa" and urged their development partners "to refrain from pursuing negotiating objectives that would adversely affect these existing programmes and process for economic integration in Africa" (African Union, 2006).

The proliferation of bilateral FTAs may also pose new challenges to the coherence of the multilateral system (Lamy, 2007). One of these challenges is related to the management of several PTAs with diverse countries and different terms, which may complicate the work of national customs authorities and firms. Customs administrations would have to apply different treatments and import fees to the same products, depending on their origin, and also follow different rules of origin according to the terms of each trade agreement.

North-South FTAs have the potential to provide the developing-country partner with new trading opportunities ...

... but such preferences may be eroded if the same developed country also concludes FTAs with other developing countries.

This may place significant pressure on the personnel and financial resources of developing countries. Furthermore, exporting firms may have to adapt their use of imported inputs to each specific market in order to comply with the rules of origin agreed in each case. More generally, this intricate network of preferential arrangements may also undermine some of the pillars of multilateralism, such as the MFN clause.

However, observers in the EU and the United States, which have been the most active in promoting bilateral North-South FTAs, believe that such agreements do not necessarily undermine the multilateral trading system; rather, that they could actually help put the multilateral negotiations back on track. From the EU perspective, bilateral agreements must "serve as a stepping stone, not a stumbling block for the widest possible openness in the global trading system" (Mandelson, 2006). And, reflecting the position of the United States, Zoellick (USGAO, 2004) stated that FTAs are part of "... a strategy of 'competitive liberalization' to advance free trade globally, regionally, and bilaterally (...). Having a strong bilateral or sub-regional option helps spur progress in larger negotiations. The recent disappointment in Cancun provides a case in point. A number of 'won't do' countries that frustrated the 'can do' spirit of Doha are now rethinking the consequences as the United States vigorously advances FTAs around the world."

In their bid to include chapters on the "Singapore issues", such as investment, competition policy and government procurement, and other areas that have been excluded from the agenda of the multilateral trade negotiations, FTAs are thus a major vehicle for deeper integration. They lock in orthodox policy reforms that have a fairly modest record in terms of enhancing growth and structural change in developing countries and whose underlying principles have come under increasing criticism, including from within the international financial

institutions (*TDR 2006*, chap. II).²⁶ Thus, it would be prudent for developing countries to be cautious and not to rush into North-South bilateral or regional FTAs. When assessing the potential economic and social benefits and costs of entering into such agreements, they should take into account not only

the potential impact on exports and imports arising from market opening, and possible increases in FDI, but also the impact of these agreements on their ability to use alternative policy options and instruments in the pursuit of a longer term development strategy.

C. Assessing the development impact of North-South regional integration: the case of NAFTA

1. Introduction

When the North American Free Trade Agreement (NAFTA) between Canada, Mexico and the United States came into force in January 1994, it was the first regional agreement of this kind to involve developing and developed countries. An assessment of the effects of NAFTA from the developing-country perspective is of particular relevance, as NAFTA has often been considered a model on which to base other North-South trade agreements. In the past few years, NAFTA has been the subject of numerous studies that have produced fairly diverse and controversial results stemming from the ideological position of their authors and the methodology applied. On balance, the conclusion drawn is that the overall impact of the Agreement in terms of development gains for Mexico has been modest.

Estimation exercises in the run-up to NAFTA, mostly based on applied general equilibrium models, produced varied results, depending on the methodology and assumptions. A review of several of these studies by the United States Congress-

sional Budget Office (1993) found a consensus that NAFTA would produce winners and losers, but a total net gain. The effects on Mexico were expected to be the most substantial, because of its greater trade barriers and smaller economy than those of its NAFTA partners. Most of the studies also estimated that improved resource allocation as a result of trade liberalization under NAFTA would raise Mexico’s GDP, but by less than 1.1 per cent. When the effects of economies of scale were included, estimates of the increase in Mexico’s GDP ranged from 1.7 per cent to around 3.4 per cent, but they were much higher if investment effects were also considered, ranging from 3.1 per cent to around 12.7 per cent. Moreover, according to this review, the

On balance, the overall impact of NAFTA in terms of development gains for Mexico has been modest.

most important effect would come from productivity growth. A rough comparison of these estimates with the actual real GDP growth rates in Mexico since 1994 (3.1 per cent on average per year, compared to 3.9 per cent in 1989–1993 (table 3.1)) suggests that many of these models overestimated the effects of NAFTA on Mexican economic growth. On the other hand, the models tended to underestimate the impact of NAFTA on trade expansion.²⁷

Table 3.1

**REAL GDP GROWTH RATES IN MEXICO
AND LATIN AMERICA, 1971–2006**

(Per cent)

	1971– 1980	1981– 1988	1989– 1993	1994– 2000	2001– 2006
Mexico	6.4	0.6	3.9	3.6	2.3
Latin America (excl. Mexico)	5.5	2.0	1.6	2.9	3.4

Source: UNCTAD secretariat calculations, based on *UNCTAD Handbook of Statistics* database.

While the Agreement has succeeded in increasing Mexico's regional trade and inward foreign direct investment (FDI), it does not appear to have helped accelerate output growth, nor does it seem to have contributed significantly to employment growth or to much higher standards of living of the Mexican people, contrary to the expectations of many of its advocates. However, some of them suggest it was not that NAFTA failed to deliver, but that other factors, such as a credit crunch or insufficient structural reforms, prevented Mexico from deriving full benefits from the Agreement (box 3.1).

It is generally acknowledged that such an empirical assessment is rendered difficult because the effects of NAFTA cannot be disentangled from other events, such as the liberalization wave that Mexico unilaterally started in the mid-1980s, the peso devaluation and the "tequila" financial crisis of 1994–1995, as well as the economic cycle in the United States. However, studies on the first decade of NAFTA tend to assume that these factors were completely independent of the processes leading up to the Agreement and that, once established, NAFTA did not have any influence on them – an assumption that appears to be somewhat unrealistic.

Unilateral trade liberalization within the broader economic reform programme started in Mexico after the debt crisis of the early 1980s, and accelerated in the early 1990s in anticipation of NAFTA. Thus Mexico was already a very open economy even before the Agreement took effect.

Indeed, NAFTA membership has often been regarded as a culmination of orthodox policy reforms in Mexico and as a way to lock them in (Moreno-Brid, Ruiz Nápoles and Rivas Valdivia, 2005; Lenderman, Maloney and Serven, 2003; and Kose, Meredith and Towe, 2004).

In the years preceding the creation of NAFTA, privatization of the banking sector in 1987 and the Brady Plan for debt restructuring in 1989 attracted capital inflows, which, rather than raising productive investment, were accompanied by a boom in private consumption. At the same time, the Government followed a policy of fighting inflation through an exchange-rate anchor with the dollar to reduce the inflation gap with the United States. The result of this policy, pursued in anticipation of NAFTA, was an overvalued currency in real terms and a significant current-account deficit financed by the private capital inflows, which paved the way for the "tequila" financial crisis. There can be little doubt that Mexico's economic performance and the evolution of the country's external economic relations have been strongly influenced by the policy decisions made in response to that crisis. Moreover, the Mexican business cycle has become more synchronized with that of the United States due to the increasing concentration of exports to this market since 1994.

This section first provides an overview of the objectives and instruments of NAFTA, and then examines how Mexico's external trade and financial relations, particularly with its NAFTA partners, have evolved since the mid-1990s. Finally, it discusses structural and macroeconomic aspects of Mexico's development in the context of the country's NAFTA membership.

2. Objectives and instruments of NAFTA

NAFTA treats trade liberalization, including of services, as its major objective, rather than as an instrument for enhancing growth and development or achieving income convergence.²⁸ In its principles, it goes far beyond market access issues involving the elimination of tariffs and the removal of non-tariff barriers in merchandise trade, to cover the liberalization of trade in serv-

Box 3.1

DIFFERING ASSESSMENTS OF NAFTA

Hornbeck (2004) provides a summary of the results of some recent analyses of the impact of NAFTA on Mexico. Among the more positive evaluations, a World Bank study by Lenderman, Maloney and Serven (2003: v) concludes that “the treaty has helped Mexico get closer to the levels of development of its NAFTA partners” but “the study argues that NAFTA is not enough. Hopes that Mexico would make bigger strides in catching up to the U.S. were diminished by under-investment in education, innovation and infrastructure, as well as low institutional quality”.^a However, Weisbrot, Rosnik and Baker (2004) challenge the conclusions of this study in terms of per capita GDP convergence, questioning the data used.

According to an IMF study by Kose, Meredith and Towe (2004: 5 and 29), “NAFTA also appears to have favourably affected Mexico’s growth performance over the past decade” and “Mexico’s experience under NAFTA illustrates that structural reforms are needed to sustain the benefits of comprehensive trade agreements”. Tornell, Westermann and Martínez (2004) argue that the lack of spectacular growth in Mexico cannot be blamed on either NAFTA or other reforms, but on the lack of further judicial and structural reform after 1995, which aggravated the credit crunch.

However, there have also been a number of critical analyses on the effects of NAFTA. According to Moreno-Brid, Ruiz Nápoles and Rivas Valdivia (2005: 1018–1019), “The fundamental constraints on Mexico’s growth have not been alleviated ... [NAFTA] has not been the success expected in terms of economic growth and job generation”. Another study (Moreno-Brid, Rivas Valdivia and Santamaría, 2005) seeks to explain why the post-NAFTA economy has displayed mixed results, with low inflation, a low budget deficit and a surge in non-oil exports, on the one hand, and a slower than expected expansion of economic activity and employment on the other.

Hufbauer and Schott (2005: 2) find that during the first decade of NAFTA “Mexico’s progress was insufficient to address its long-run development challenges and well below its estimated potential growth rate”. According to Blecker (2003), Mexico completely failed to close the “development gap” with the United States and Canada in the first 10 years of NAFTA. Ramírez (2003) finds that the record in terms of employment growth and real wages in the manufacturing sector has been lacklustre at best and disastrous at worst, while distributional indicators performed poorly during the 1990s. Also focusing on people, Audley et al. (2003) conclude that NAFTA has not helped the Mexican economy keep pace with the growing demand for jobs, while NAFTA-led productivity growth has not translated into increased wages, and the Agreement has not stemmed the flow of Mexican emigration to the United States.

^a See the following World Bank website: <http://go.worldbank.org/EJLC6GB370>.

ices, including financial services, as well as other regulatory issues. Unlike some other regional agreements, NAFTA does not envisage deeper economic integration or cooperation in areas such as infrastructure, finance or social development once the members have eliminated trade and investment barriers among themselves.²⁹

The institutional structure of NAFTA does not include any supranational element. The central institution is the Free Trade Commission, which consists of the three ministers responsible for international trade in the three member States. This Commission supervises the implementation of the Agreement, oversees its further elaboration,

resolves disputes arising from its interpretation and supervises the work of several committees and working groups. The NAFTA Secretariat administers the mechanisms for the resolution of trade disputes between national industries and/or governments. As the three member countries have retained their own trade remedy laws, the trade dispute settlement mechanism is the main institutional instrument of NAFTA (Raynauld, 2007).³⁰

The trade and investment aspects of the Agreement are complemented by side agreements on labour and environmental cooperation to promote better environmental performance and working conditions in North America. However, on some accounts, in order for these side agreements – and the institutions linked to them – to address the environmental and labour challenges arising from increased trade more effectively, they need to be improved.³¹ Inside NAFTA, there is a predominance of bilateral cooperation between the United States and the other two partners (Pastor, 2004). An example of this kind of cooperation is the North American Development Bank, which addresses environmental issues along the United States-Mexico border region. Nevertheless, there are also examples of trilateral cooperation, such as the North American Steel Trade Committee, which brings together officials of the three governments and representatives of steel manufacturers to address critical trade issues in global steel markets.

Most tariffs were eliminated in the first 10 years of the Agreement, except for some sensitive goods, mostly agricultural, for which extended phasing out periods of up to 15 years were agreed. Given Mexico's strong dependence on the United States market, this undermines Mexico's ability to use tariffs as an instrument of strategic trade integration (*TDR 2006*: xi). The Agreement is based on full reciprocity, which means that it does not take into account the large asymmetries of the economies

of the member countries, except for granting longer transition periods for sensitive Mexican products and the exclusion of some strategic sectors, such as energy. Moreover, since Mexico initially had much higher tariffs than its NAFTA partners, it had to make more substantial tariff concessions. On the other hand, the Agreement does not impose any restrictions on the use of agricultural subsidies; these are used extensively by the United States, where they account for 37 per cent of the value of total agricultural output (United States Congressional Budget Office, 2006). Restrictive rules

of origin to determine which goods are entitled to preferential treatment under NAFTA are also an important part of the Agreement. Anson et al. (2005) note that the cost of complying with these rules of origin has eroded the benefits that Mexico might have gained from preferential market access. Cadot et al. (2005) arrive at a similar conclusion in their study on the textiles sector under NAFTA, suggesting there has been little improvement in market access for Mexican exporters.

NAFTA incorporates comprehensive provisions dealing with cross-border trade in services, with specific chapters for financial services and telecommunications. Liberalization of services is regulated by a negative list approach, which is more extensive than the positive list of the WTO's General Agreement on Trade in Services (GATS).

As a result, many essential services, such as financial services, could be controlled by foreign interests, which entails the risk that their management may not be in line with the country's development priorities. NAFTA also facilitates the temporary cross-border movement of certain categories of persons, including business visitors, skilled labour in selected professions, intra-corporate transferees, and traders and investors (UNCTAD, 2007b); low-skilled workers who tend to migrate from Mexico to the other NAFTA members are excluded from this liberalization of cross-border movements.

In NAFTA trade liberalization is a major objective, not an instrument for enhancing growth and development or achieving income convergence.

NAFTA covers regulations on "deeper" integration in areas such as investment, intellectual property rights, government procurement and competition policy.

In addition, NAFTA covers “deeper” integration in areas such as investment, intellectual property rights, government procurement and competition policy, most of which are generally referred to as “WTO-plus” or “beyond-the-border” measures. Regulation in these areas may limit the flexibility available to policymakers to implement proactive policies for the creation of productive capacities and technological upgrading. Such policies played an important role in the earlier phases of development of today’s most advanced countries and in the successful catching up process of some Asian economies.³²

NAFTA includes provisions for liberalization of FDI and foreign investor protection that are more restrictive than those that have been negotiated, or are under negotiation, at the multilateral level. These provisions address all measures regulating FDI, and not only those considered “trade-related” that are regulated by the WTO Agreement on Trade-related Investment Measures (TRIMs). As in the case of services, coverage is determined by a negative list, which includes strategic sectors

such as energy. Foreign investors from the United States and Canada are granted national and most-favoured-nation treatment in Mexico. The Agreement also contains “pre-establishment” rights, a ban on a wide range of performance requirements, a broad definition of expropriation, and a mechanism of dispute settlements that also deals with investor–State disputes. Thus, Mexico is prevented from using most investment measures that could support the creation of linkages between foreign investors from other NAFTA countries and local manufacturers. These measures could nurture the latter while increasing the domestic value added, thereby generating additional national income and employment, as well as encouraging the transfer of technology. In addition, the broad definition of investment in NAFTA – including portfolio investment – together with the free transfer of funds, allows virtually free capital mobility.³³

NAFTA rules on intellectual property rights are also stricter than those of the WTO Agreement on Trade-related Aspects of Intellectual Property Rights (TRIPS), which is already quite restric-

tive.³⁴ However, as NAFTA pre-dates TRIPS and was used as a model for intellectual property regulations, the differences between NAFTA and TRIPS rules are fewer than those relating to investment.³⁵ The NAFTA provisions are far more constraining for Mexico than for the United States and Canada: they limit its access to technology, knowledge and medicines, and consequently reduce the possibility of learning and technological progress through imitation. In addition, the fiscal discipline imposed by the Mexican authorities has limited the resources available for public investment in research and development (R&D) and innovative activities. According to UNESCO (2005), gross expenditure on R&D as a percentage of GDP in Mexico was 0.4 per cent in 2000, below the Latin American and Caribbean average of 0.6 per cent, and much lower than the 1.8 per cent of Canada and the 2.8 per cent of the United States.

NAFTA allows Mexico little room to use industrial policy as an instrument for development.

Under the same general principles of national treatment and non-discrimination, liberalization of government procurement implies that companies from other NAFTA countries have the same access to

government contracts as local companies. Thus the Mexican Government can no longer use this instrument for supporting the development of domestic firms.

Therefore NAFTA allows Mexico little room to use industrial policy as an instrument for development. Since the mid-1990s, Mexico has adopted medium- to long-term plans for the development of its industrial sector (*TDR* 2006: 182–186), but the main instrument of industrial policy has been tax exemptions for imported goods destined for re-exportation (Moreno-Brid, Rivas Valdivia and Santamaría, 2005). Other instruments, such as export subsidies, trade protection schemes or performance requirements, have been prohibited. Mexico retains the right to provide subsidies for science and technology and human capital development but, as mentioned before, fiscal discipline imposes a constraint. Regarding industrial policy, the National Plan for Development (2001–2006) had as a core objective the promotion of domestic value added and the strengthening of linkages among local production chains. It recognized a

leading role for the State for promoting international competitiveness, and the need for formulating sector-specific policies. The aim was to design specific sectoral programmes in several industries, but by the end of 2006 only four had been launched: for electronics, software, leather and footwear, and textiles. In November 2006, a new programme, IMMEX, was launched to promote the manufacturing, *maquila* and service export industries. It simplified the procedures for exporting firms to apply to the PITEX programme for temporary imports of inputs for use in the production of goods for export, reduced the waiting period for value added tax (VAT) returns, and allowed firms exporting services to receive the same benefits as exporters of manufactures under PITEX. However, the change in the orientation of industrial policy, from horizontal policies to more sector-specific measures, has so far been more rhetorical than real due to insufficient budgetary funds and long delays in implementation (Moreno-Brid, 2007). Peres (2005) points out that sectoral measures have focused mainly on supporting and expanding already existing sectors, rather than promoting structural change by supporting new and innovative activities with greater potential for the generation of domestic value added.

3. Expansion of intraregional trade and financial relations

Since NAFTA entered into effect, intraregional trade and FDI flows have increased significantly, particularly for Mexico. The unweighted average of NAFTA intraregional exports in total exports increased from 63.5 per cent in 1990–1994 to 70.2 per cent in 2002–2006, while intraregional imports in total imports declined from 54.4 per cent to 50.3 per cent over the same period (table 3.2). Intraregional exports as a percentage of total exports increased considerably for all three member countries. The share of intraregional imports in total imports rose for the United States, but declined for Canada and Mexico. Table 3.2 also shows that intraregional trade is much more important for Canada and Mexico than it is for the United States. For Mexico, the share of exports to the United States in its total exports

Table 3.2

INTRAREGIONAL TRADE OF THE NAFTA COUNTRIES, 1990–1994 AND 2002–2006

(Annual average in per cent)

	Exports		Imports	
	1990–1994	2002–2006	1990–1994	2002–2006
Canada	79.0	85.9	65.7	62.7
Mexico	81.9	88.2	72.5	60.6
United States	29.6	36.5	25.1	27.6
NAFTA ^a	63.5	70.2	54.4	50.3

Source: UNCTAD secretariat calculations, based on IMF, *Direction of Trade Statistics* database.

a Unweighted average.

rose from an annual average of about 62 per cent in the 1980s to about 80 per cent in the period 1990–1995 and 86 per cent in 2001–2006 (IMF, *Direction of Trade Statistics* database), making Mexico the developing country with the highest concentration of exports to a single destination and the one with the largest increase in export opportunities from world import demand growth (*TDR 2006*: tables 3.2 and 3.5).³⁶ The closer integration of Mexico with the United States economy since the early 1990s has led to a convergence of the business cycles of the two countries, implying an increased dependence of Mexico's economy on the performance of the United States economy.

Mexico's total exports surged, growing at an average rate of 11.3 per cent during the period 1994–2006, compared to 7.1 per cent between 1981 and 1993. The share of Mexico in total world trade increased from 1.4 per cent in 1994 to 2.6 per cent in 2000, but then declined to 2.1 per cent in 2006 (*UNCTAD Handbook of Statistics* database). Imports grew at similar rates, and by 2006 they were over three times their value of 1994. This is primarily the result of the increasing structural dependence of the Mexican economy on imports (Moreno-Brid, Rivas Valdivia and Santamaría, 2005), partly due to the high import content of Mexican exports, particularly in the *maquiladora* sector.³⁷

Figure 3.2

MEXICO: EXPORTS, IMPORTS, TRADE BALANCE AND REER, 1980–2006

(Billions of dollars and index numbers)



Source: UNCTAD secretariat calculations, based on UNCTAD Handbook of Statistics database; and OECD, Factbook 2007 online.

As a result, overall, Mexico's trade balance has been in deficit since 1994, except during the period 1995–1997 (i.e. in the aftermath of the *tequila* financial crisis and under the influence of a sharp currency devaluation) (fig. 3.2). By contrast, Mexico has registered an increasing trade surplus with the United States, which is mainly a reflection of that country's large trade deficit. But this surplus is not sufficient to compensate for Mexico's overall trade deficit with the rest of the world. It has also recorded a current-account deficit in all the years that NAFTA has been in force. Indeed, in the early 2000s the current-account deficit approached the levels of the period prior to the peso devaluation of 1994, but thereafter these levels fell.

The composition of Mexican exports has changed dramatically since the 1980s. At the beginning of that decade, in a period of relatively high oil prices, this commodity accounted for around 60 per cent of its total exports. Towards the end of the 1990s, the share of oil fell to 10 per cent, and since then it has risen slightly as a result

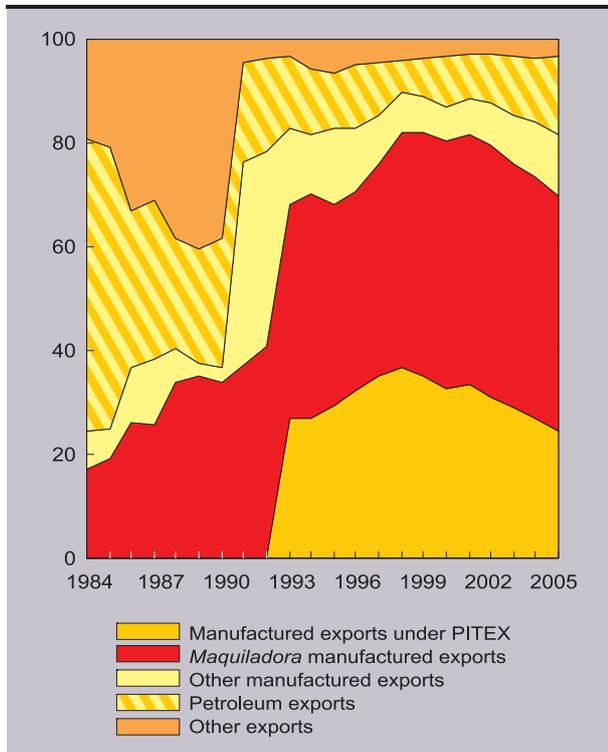
of the new oil price hike. There has also been a significant decline in the share of agricultural products in total exports. On the other hand, the share of manufactures in total exports increased from around 30 per cent in the early 1980s to close to 90 per cent by the late 1990s, although it subsequently fell to around 80 per cent in 2005 and 2006 (fig. 3.3). However, this is not just a feature of the NAFTA period, since even before NAFTA, between 1981 and 1993, there was already rapid export growth of manufactures. Moreover, Mexico's manufactured imports have consistently been growing as fast as its exports (fig. 3.4).

Mexico is a major exporter among developing countries of manufactured goods, such as textiles and clothing, automobiles and automotive parts, and electrical and electronic goods,³⁸ which have been very important in international production networks. In the labour-intensive textiles and clothing sector, increasing bilateral trade between Mexico and the United States following the creation of NAFTA was a sign of the regionalization of trade; regulations under NAFTA have favoured

Figure 3.3

STRUCTURE OF MEXICO'S EXPORTS, BY TYPE, 1984–2005

(Per cent)



Source: UNCTAD secretariat calculations, based on *Secretaría de Economía, Estadísticas de Comercio Exterior del Sector Manufacturero* and *Information on PITEX*, at: www.economia.gob.mx; *Banco de Mexico* database, at: www.banxico.org.mx/; and Capdevielle, 2005.

Note: Other exports comprise agricultural commodities and extractive industries.

an ongoing transition from assembly to a more full-package type of production in Mexico. Moreover, NAFTA rules of origin provided an advantage, as Mexican inputs into goods for export count as North American inputs and are not taxed at the United States border. A similar pattern of bilateral trade in electronic goods between the United States and Mexico has evolved since the mid-1990s. NAFTA also gave new momentum to the Mexican automotive industry, which had originally been established in the 1960s in the context of import-substituting industrialization. It further deepened a restructuring process in terms of productivity levels and export orientation, as it pro-

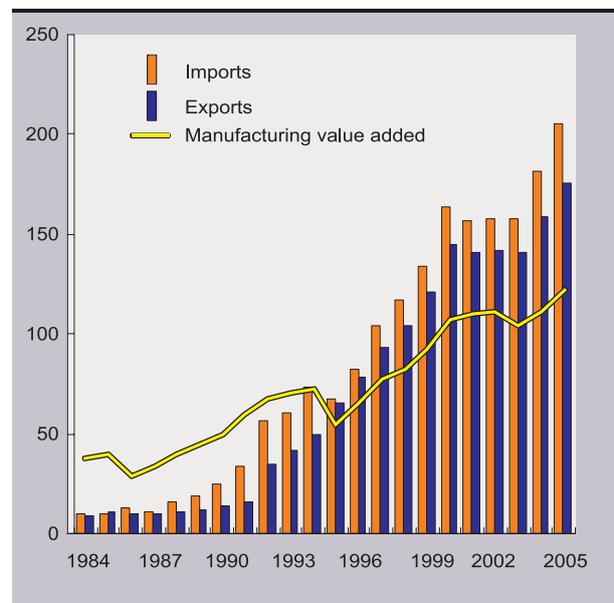
vided preferences that benefited United States transnational corporations (TNCs) and extended regional rules of origin to producers of non-American origin, including component producers. Thus the surge in bilateral trade after NAFTA appears to have consolidated the position of Mexican producers as part of the regional industrial bloc. It also consolidated a process of regional restructuring as a result of leading United States producers intensifying production sharing through offshore assembly sites (*TDR 2002*: annex 3 to chap. III).

Exports of the *maquiladora* sector, which grew at an average rate of 12.6 per cent between 1994 and 2006 made an important contribution to the country's average growth in manufactured exports of 11.5 per cent. However, *maquiladora* industries are confined to labour-intensive, assembly-

Figure 3.4

MEXICO: TRADE AND VALUE ADDED IN MANUFACTURES, 1984–2005

(Billions of dollars)



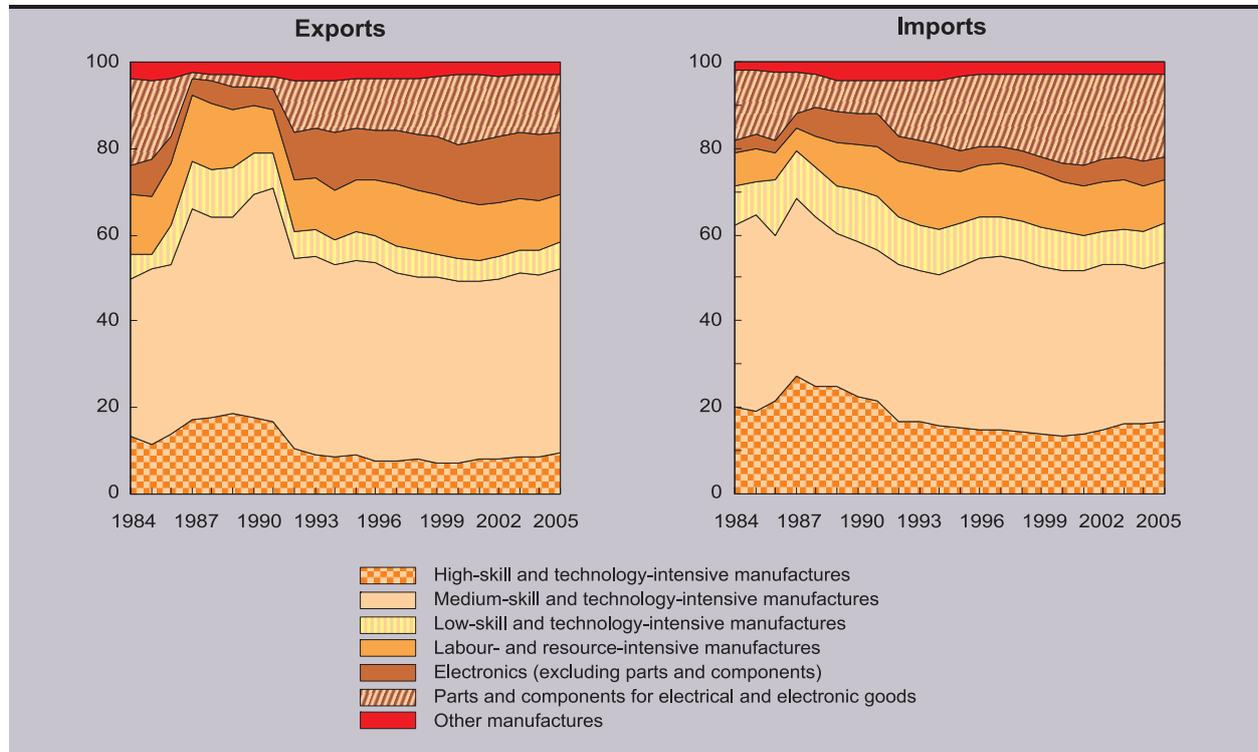
Source: UNCTAD secretariat calculations, based on *UNCTAD Handbook of Statistics* database; and UN COMTRADE.

Note: To ensure data comparability, the definition of manufactures in trade data follows the ISIC classification of industrial statistics. It therefore includes processed primary products in addition to manufactures as defined in trade statistics.

Figure 3.5

**COMPOSITION OF MEXICAN MANUFACTURED EXPORTS AND IMPORTS
BY BROAD PRODUCT CATEGORY, 1984–2005**

(Per cent)



Source: UNCTAD secretariat calculations, based on UN COMTRADE.

Note: For the composition of product categories, see the notes to chapter IV.

type activities, with little domestic value added. *Maquiladora* exports represented on average 27 per cent of total Mexican exports and about 48 per cent of manufactured exports during the period 1981–1993. These shares increased to 45 per cent and 52 per cent, respectively, in the subsequent period, 1994–2006.

In the context of Mexico’s surging trade since the early 1990s, it is interesting to look at the composition of trade in manufactures by skill and technology intensity. It is also important to consider not only the types of products exported but also the processes involved in exports: a high-technology content in export products may result from low-technology processes. All product categories of manufactured exports experienced rapid growth between 1994 and 2005. However, their composition by skill and technology intensity remained

relatively unchanged over this period. Medium- and high-skill and technology-intensive manufactures represented over half of total manufactured exports, while low-skill and technology-intensive and labour- and resource-intensive manufactures accounted for only about 17 per cent of total manufactured exports (fig. 3.5). But, despite the fact that a significant proportion of Mexican exports are classified as skill- and technology-intensive products, Mexican firms have been involved mainly in the low-skill, assembly stages of the production of such goods (*TDR 2002*: v, 53). The technology content of Mexico’s exports may be high, but this does not necessarily imply domestically generated high-technology inputs.

Compared to exports, manufactured imports, which also grew rapidly, consisted of a larger proportion of high-skill and technology-intensive

products and electronic parts and components in total manufactured imports. The data also point to the growing importance of intermediate goods in imports. Much of this is related to the increasing weight of the *maquiladora* industry in manufactures, which uses only about 2 per cent of inputs of local origin (Pacheco-López, 2005) and has low linkages with the rest of the economy. Exports of the *maquiladora* industry, together with those of the PITEX programme – an assembly programme which displays similar characteristics to the *maquiladoras* in terms of its high import content – reached about 90 per cent of total manufactured exports, on average, between 2000 and 2005 (fig. 3.3). Thus, even though there has been diversification in Mexican exports since the 1980s, with a reduction in the share of commodities in total exports, trade specialization in manufacturing is focused mainly on labour-intensive processes. Trade liberalization and NAFTA have maintained the static comparative advantage of Mexico in low-cost labour. Nonetheless, Palma (2005) highlights the potential of non-*maquila* manufactured exports to contribute to catch-up growth through acquired comparative advantages and technological upgrading.

Mexican trade specialization in manufacturing remains focused on labour-intensive processes.

The sustainability of Mexico's export growth, which relies heavily on the supply of cheap, low-skilled labour, is challenged by increasing competition from lower cost exporters in Asia, especially China since its accession to the WTO in 2001. In addition, the extension of trade preferences by the United States to other developing countries through bilateral and regional agreements may considerably reduce any "first-mover" advantages Mexico may have had from its membership of NAFTA. Increased global competition is already reflected in the reduced dynamism of some important export products in Mexico in the 2000s. Indeed, while the share of Mexico's manufactured exports in world exports increased from 1.4 per cent in 1994 to 2.7 per cent in 2000 and 2001, it declined subsequently to 2.1 per cent in 2005 (table 3.3). *TDR 2005* (table 2.10) showed, for example, how the market share of Mexico in United States apparel imports grew considerably up to 1999 but declined thereafter.

Mexico has also benefited from a sharp increase in FDI inflows since 1994, in a context of an overall expansion of FDI flows to developing countries. Although FDI flows to Mexico have shown considerable volatility related to various developments in the global economy, such as the Asian financial crisis or the slowdown of the United States economy in the early 2000s, the overall trend has been positive. On average, between 1990 and 1994 FDI inflows into Mexico were in the order of \$5 billion, rising to about \$19 billion in 2000–2004.³⁹ FDI stocks as a percentage of GDP increased from 8.5 per cent in 1990 to 27.3 per cent in 2005, when Mexico ranked fourth among developing countries as a recipient of FDI flows and third in terms of FDI stock (UNCTAD *WIR* database). The United States has been the main source of FDI to Mexico, its share in Mexico's total inward FDI increasing from 47 per cent in 1994 to 64 per cent in 2006. During this period, on average, 54 per cent of foreign investment went to the manufacturing sector. However, since the late 1990s, FDI in services has become more important, particularly in financial services (Secretaría de Economía, *FDI Statistics*).

FDI flows to Mexico have been motivated mainly by low labour costs and its geographical position as an export platform to the United States. Mexico has become a major player in the context of international production networks to serve global and regional markets, primarily the United States market. The global fragmentation of production has resulted in Mexico increasingly importing parts and components for assembly and re-export to the United States. Thus an important part of the value added contained in these products accrues to foreign owners of capital, know-how and management. NAFTA has encouraged this process through the preferential market access granted to goods produced by the Mexican assembly operations of Canadian and United States TNCs, as well as to goods that contain inputs originating in these countries. The process has also been helped by fiscal and other incentives to attract FDI, offered in the hope that TNCs would provide technological and knowledge spillovers to domestic producers. However, the

Table 3.3

MEXICO: NAFTA-RELATED PERFORMANCE INDICATORS

(Per cent)

	1990	1994	2001	2005/06
Manufactured exports as a share of world manufactured exports	0.5	1.4	2.7	2.1
Manufacturing value added as a share of world manufacturing value added	1.1	1.4	2.0	1.7
Total manufactured exports as a share of GDP	5.2	11.8	22.6	22.9
Manufactured exports to NAFTA as a share of GDP	4.0	10.6	20.8	20.5
Manufacturing value added as a share of GDP	20.6	18.2	19.2	17.5
Inward FDI stock as a percentage of GDP	8.5	7.9	22.6	27.3
GDP per capita as a percentage of United States GDP per capita (PPP)	26.9	27.1	26.1	24.4
Ratio of gross fixed capital formation to GDP	17.9	19.4	20.0	19.3
Inflation	29.9	7.1	4.4	4.1
Mexican nominal wage as a percentage of United States nominal wage (in manufactures)	..	17.5	16.9	17.3

Source: UNCTAD secretariat calculations, based on *UNCTAD Handbook of Statistics* database; UN COMTRADE; World Bank, *World Development Indicators* database; UNCTAD, *WIR* database; and Instituto Nacional de Estadística, Geografía e Informática (INEGI) database.

Note: To ensure data comparability, the definition of manufactures in trade data follows the ISIC classification of industrial statistics. It therefore includes processed primary products in addition to manufactures as defined in trade statistics.

problem with this efficiency-seeking kind of FDI is that it has failed to establish strong linkages with Mexico’s domestic economy because it has rarely gone beyond assembly activities.⁴⁰ According to some observers, this has led to a dual economy, with a relatively small number of firms in the export-oriented sector benefiting from this investment, particularly in the northern part of the country, while the rest of the economy has been lagging behind (Moreno-Brid, Rivas Valdivia and Santa-maría, 2005; Pacheco-López, 2005).⁴¹

4. Mexico’s economic and social performance after NAFTA

Mexico’s strong export growth and FDI inflows under NAFTA have not translated into similarly strong economic and social progress. Indeed, the outcome of NAFTA has been disappointing with regard to key macroeconomic variables and social indicators.

Mexico’s share in world manufactured exports almost doubled between 1994 and 2001 – declining subsequently – while its share in world manufacturing value added rose much less (table 3.3). Moreover, the share of manufactured exports in Mexican GDP rose significantly during the 1990s as a result of increased participation in international production networks, but the share of manufacturing value added in GDP fell. Both these shares have been exhibiting a declining trend since the beginning of the new millennium. Figure 3.4 shows how Mexico’s imports and exports of manufactures have been significantly exceeding manufacturing value added since 1994, although previously it was the reverse. Moreover, growth in value added has been low in comparison with the surge in manufactured imports and exports, leading to a declining share of value added in exports.⁴²

Since NAFTA came into effect, Mexican GDP growth has been unstable, following closely the business cycle of the United States. However, from a medium-term perspective, the launching

of NAFTA did not improve the Mexican growth trend, nor did it help to narrow the gap between Mexican per capita GDP and that of the other member countries. Regarding growth, Mexico's average post-NAFTA GDP growth rate of 3.6 per cent in 1994–2000 was slightly below that of 1989–1993, though higher than that of the rest of Latin America and the Caribbean. It then fell in 2001–2006 to an average of 2.3 per cent per annum, almost 1 percentage point lower than for the rest of the region (table 3.1). The income gap with the United States, which had widened dramatically during the “lost decade” of the 1980s, widened further after 1994: in 1982, the Mexican per capita GDP in PPP terms was 38.4 per cent that of the United States; that ratio declined to 27.1 per cent in 1994, and to 24.4 per cent in 2005 (table 3.3).

The share of exports in Mexico's GDP, in current dollars, jumped from 17 per cent in 1994 to 30 per cent in 1995, largely due to the devaluation of the peso, and it has remained at around that level ever since. However, the share of imports in GDP expanded at a similar pace, from 21.7 in 1994 to 31.6 in 2005. As a result, the contribution of net exports to real GDP growth has been very low (1 per cent between 1994 and 2005). Rather, it was private consumption that contributed to about three quarters of real GDP growth between 1994 and 2005. Similarly, the contribution of investment (about 18 per cent) to real GDP growth has been higher than that of net exports, albeit still low (ECLAC, 2006a). Thus, despite its spectacular export growth, it cannot be concluded that Mexico has witnessed export-led growth.

As already mentioned, FDI inflows as a percentage of GDP are on average higher than before NAFTA. However, this has not translated into an increased share of gross fixed capital formation (GFCF) in GDP, which has remained at around 20 per cent (table 3.3). This level is well below the 25 per cent that is generally understood to be required for a sustained process of catch-up growth in a middle-income developing country such as Mexico (*TDR 2003*: 61). A dynamic nexus between exports, domestic investment and income

growth that would allow Mexico to rapidly narrow the income gap with its developed NAFTA partners thus remains to be established.

There is no evidence of accelerated change in the structure of production of the Mexican economy since the early 1990s.⁴³ The relative share of industrial value added in GDP remained almost the same between 1994 and 2005, while that of services increased slightly at the expense of agriculture (UNCTAD *Handbook of Statistics* database). In its industrial activities, there was some increase in the share of technology-intensive production, from 32.5 per cent in 1994 to 37.3 per cent in 2003. This was probably associated with the growing activities in the automotive industry after the creation of NAFTA. However, resource-intensive manufactures have maintained the largest share in the country's industrial activity, even though it declined from 47.2 per cent in 1994 to 45.4 in 2003. The share of labour-intensive manufactures also declined from 20.2 to 17.4 per cent over the same period (*TDR 2006*, fig. 5.2).

In certain other sectors, liberalization of trade and services under NAFTA has had serious negative consequences. In agriculture, producers of maize, which is a major staple food crop for Mexico, have been adversely affected by an increase in imports from the United States. Corn prices fell due to the Mexican market being flooded with cheaper imported corn produced more efficiently and heavily subsidized. The smallest and poorest farmers, unable to compete, have suffered the most. The increase in exports of some agricultural products, mainly fruit and vegetables, has not been strong enough to compensate for the substitution of domestic agricultural products through imports of others (Khor, 2007b). According to Zahniser (2007), United States exports of grains and feeds and oilseeds products to Mexico increased almost threefold between 1991–1993 and 2003–2005, while its exports of animals and animal products to Mexico doubled, and exports of corn increased sixfold over the same period. As a result of Mexico's liberalization of its financial services, foreign ownership of the

Mexico's strong export growth and FDI inflows under NAFTA have not translated into similarly strong economic and social progress.

banking system rose to about 80 per cent by the end of 2005 (IMF, 2006). So far, restructuring of the banking system has not improved access to credit: indeed, bank credit to the private sector as a proportion of GDP declined from 32.2 per cent in 1994 to 16.7 per cent in 2006 (IMF, *International Financial Statistics* database).⁴⁴

The banking and balance-of-payments crisis that struck shortly after NAFTA was launched had a strong influence on much of the subsequent macroeconomic situation. Inflation rose to more than 50 per cent in 1995 and the real effective exchange rate (REER) depreciated markedly. Macroeconomic policy was successful in cutting inflation without new shock therapies. Since 2001, the inflation rate has remained below the pre-crisis level, and has continued to fall to reach 4.1 per cent in 2006 (INEGI database), as the Bank of Mexico has been strongly committed to its inflation target through tight monetary policies. Meanwhile, the REER has tended to appreciate, especially between 1995 and 2002, although it still remains below the pre-crisis level (fig.3.2). The relatively strong peso has contributed to the erosion of the advantages that NAFTA offers to export industries and has reduced Mexico’s export competitiveness vis-à-vis other developing countries. Mexican exporters who are not integrated into international production networks are affected the most, because given the high import content of TNCs’ exports the latter benefit from access to cheaper inputs as a result of the REER appreciation.

Employment creation is a huge challenge for Mexico, with about one million people joining the labour force every year. Partial evidence shows that total employment has increased at a rapid rate,⁴⁵ while the open unemployment rate has been maintained at a fairly low level: at 3.5 per cent in 1994 and 4.0 per cent in the first quarter of 2007. If underemployment (i.e. those working less than 15 hours a week) is also taken into account, the unemployment rate rises to 10 per cent in the first

quarter of 2007 (INEGI database and OECD, 2007). However, the majority of new jobs created were in the non-tradables sector (3.9 per cent), whereas employment growth was relatively modest in the tradables sector (1.7 per cent). Moreover, a considerable proportion of the employment was created in low-productivity or informal activities, according to the ECLAC classification (ECLAC, 2006b). According to Polaski (2006), since NAFTA took effect, the

most dramatic impact on employment has been in agriculture, where about 2 million jobs have been lost, partly due to increased imports. The share of the agricultural sector in total employment fell from 25.7 per cent in 1993 to 14.3 per cent in 2006. This seems to have been absorbed mainly by the services sector, which increased its share in total employment from 51 per cent to 60 per cent over that period. In manufactures, about 700,000 jobs were created over the same period, mainly in export-oriented manufactures, against 130,000 jobs lost in domestic manufacturing due mainly to the substitution of formerly domestically produced inputs by imports. The rising trend of employment in manufacturing has been reversed since the early 2000s.

Although NAFTA may have led to a growth in labour productivity, the productivity gap with the United States has widened, and real wages, which had declined sharply during the 1994 crisis, have not grown in parallel.⁴⁶ Indeed, the real wage index remains lower than in 1994. Since the creation of NAFTA, Mexico has made progress in reducing poverty, but income inequality remains high. The percentage of people living below the poverty line fell from 45.1 in 1994 to 35.5 in 2005,⁴⁷ and the ratio between the average income of the richest 10 per cent of the population and the poorest 40 per cent declined slightly, from 17.3 to

16.7 (ECLAC, 2006b). On the other hand, as NAFTA has contributed to better growth performance primarily in the northern parts of Mexico, through an expansion of exports and an increase

Increasing trade and FDI flows should not be considered an end in itself ...

... it can lead to faster development when combined with policies, at the national and regional levels, that encourage fixed capital formation and technological upgrading.

in FDI, regional disparities have been growing. For instance, in 1993 the GDP per capita of the poorest state, Oaxaca, was 18.4 per cent of that of the richest state, the Federal District, compared to only 16.2 per cent in 2002 (Escobar-Gamboa, 2006).⁴⁸

Perhaps the greatest disappointment with NAFTA has been that it has failed to stem migration from Mexico to the United States, particularly illegal migration, which carries high social costs. Since the standard of living and employment opportunities of the Mexican people have not significantly improved and the wage gaps with the United States have not narrowed, incentives for migration remain strong. Indeed, Mexican migration to the United States accelerated in the 1990s. The number of Mexicans obtaining legal permanent resident status in the United States almost tripled compared to the 1980s, and the share of Mexicans in the employed population in the United States rose from 3.1 per cent in 1995 to 4.8 per cent in 2005. In addition, unauthorized immigration has remained high, the number of Mexicans living without legal resident permits in the United States being close to 6 million in 2005. The boom in workers' remittances from the United States to Mexico has mirrored these trends in migration. Between 1994 and 2006, remittances to Mexico increased sixfold.⁴⁹ Remittances can be considered the positive side of migration for Mexico, as they can contribute to poverty alleviation and the financing of small-scale ventures, but their growing size also indicates that NAFTA has not significantly contributed to solving the structural problems of the Mexican economy that lead to migration in the first place.

To sum up, while it is difficult to identify precise causalities between NAFTA and the structural and macroeconomic trends in Mexico over the past 15 years, it can nevertheless be concluded that, since the creation of NAFTA, Mexico has witnessed spectacular expansion in trade and FDI flows and relative macroeconomic stabilization. However, NAFTA has produced disappointing results in terms of growth and development. In spite of its privileged access to the largest and most dynamic market in the industrial world and the large FDI inflows, the Mexican economy has so far not been able to establish a dynamic process of industrialization and structural change. The Mexican experience in NAFTA confirms that, in order to strengthen capital accumulation to expand productive capacities, technological upgrading and growth of domestic value added in manufacturing, regional cooperation should not be limited to the dismantling of barriers to trade and investment flows. And the rules associated with regional cooperation agreements should not prevent the poorer countries from pursuing a proactive industrial policy. Increasing trade and FDI flows should not be considered an end in themselves; rather, they should be a means to faster growth and development when combined with appropriate policies that favour fixed capital formation and technological upgrading, including at the regional level. Given the large asymmetries between the NAFTA member countries, the Agreement should have included some kind of compensatory funding mechanism to assist with the adjustment costs of the integration process and for developing infrastructure in the poorest areas. Compensation funds would be of particular importance for Mexico, the poorest member of NAFTA. ■

Notes

- 1 RTAs, in the WTO terminology, reflect provisions in Article XXIV of GATT 1994 (and the Uruguay Round Understanding on that Article), as well as Article V of GATS on Economic Integration. The WTO has the Committee on RTAs under its organizational structure. However, most of the South-South RTAs are functioning under the GATT Enabling Clause (1979) and are reported to the WTO Committee on Trade and Development.
- 2 See for example, Breslin et al., 2002; and Burfisher, Robinson and Thierfelder, 2003.
- 3 These figures do not include agreements that may already have been in force but were not yet notified to WTO. The World Bank estimated that there were a total of 230 trade agreements by 2005 (World Bank, 2005a: 28).
- 4 COMECON, founded in 1949, comprised Bulgaria, the former Czechoslovakia, Cuba, the former German Democratic Republic, Hungary, Mongolia, Poland, Romania, the former Soviet Union and Viet Nam. The organization was dissolved in 1991.
- 5 United States FTAs exist with Bahrain, Chile, Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras, Jordan, Morocco, Nicaragua, Oman and Singapore. As of June 2007 agreements with Colombia, Panama, Peru and the Republic of Korea were awaiting approval by the United States Congress, and ratification by Costa Rica's Parliament is also pending (see also McMahan, 2007).
- 6 For a survey of United States RTAs and FTAs with developing countries at different stages of completion, see USTR, 2007.
- 7 The EU is in the process of negotiating separate EPAs with six regional groupings (four in Africa, and one each in the Caribbean and the Pacific regions), with a view to replacing the Cotonou agreement that is scheduled to expire at the end of 2007.
- 8 Algeria, Chile, Egypt, Morocco, the Palestinian Authority, South Africa and Tunisia. In late 2006, the European Commission announced its intention to pursue additional FTAs with several Asian countries, including members of the Gulf Cooperation Council and the Association of Southeast Asian Nations (ASEAN), as well as India and the Republic of Korea.
- 9 These agreements are being negotiated between the EU and six regional bodies of 75 ACP countries: the Common Market for Eastern and Southern Africa (COMESA), the Economic and Monetary Community of Central Africa (CEMAC), the Economic Community of West African States (ECOWAS), the Southern African Development Community (SADC), the Caribbean Forum, and the Pacific countries of the ACP.
- 10 "... the Parties agree to conclude new WTO-compatible trading arrangements, removing progressively barriers to trade between them and enhancing cooperation in all areas relevant to trade" (Cotonou Agreement, Chapter 2, Art. 36.1) The GATT/WTO article related to FTAs (Art. XXIV, 8.b) does not permit non-reciprocal trade conditions within such agreements: "A free-trade area shall be understood to mean a group of two or more customs territories in which the duties and other restrictive regulations of commerce (except, where necessary, those permitted under Articles XI, XII, XIII, XIV, XV and XX) are eliminated on substantially all the trade between the constituent territories in products originating in such territories."
- 11 As a United States official report put it: "Under the Caribbean Basin Initiative, U.S. tariffs on Central American goods are already low, with 74 percent of CAFTA country imports entering the United States duty-free in 2002. An FTA would enable the United States and the CAFTA countries to have reciprocal tariff levels and would remove the requirement that Caribbean Basin Initiative preferences be reviewed every year" (USGAO, 2004).
- 12 For a discussion of the practical aspects of this issue, see Scollay (2005); Cernat, Onguglo and Ito

- (2007) offer an analysis of the implications of some recent reform proposals.
- 13 GATT Article XXXVI, paragraph 8: “The developed contracting parties do not expect reciprocity for commitments made by them in trade negotiations to reduce or remove tariffs and other barriers to the trade of less-developed contracting parties”.
- 14 GATS Article XIX, paragraph 2: “The process of liberalization shall take place with due respect for national policy objectives and the level of development of individual Members, both overall and in individual sectors. There shall be appropriate flexibility for individual developing country Members for opening fewer sectors, liberalizing fewer types of transactions, progressively extending market access in line with their development situation ...”
- 15 Comment by the Deputy United States Trade Representative, quoted in *Business Week*, 16 June 2003 (cited by Shadlen, 2007).
- 16 The United States argues that the subsidy issue can be dealt with only at the WTO.
- 17 Data from the United States Federal Procurement Data System (USFPDS, 2007) suggests that in 2005, 94 per cent of the payments made by the Federal Government went to companies located in the United States, leaving only 6 per cent to all suppliers from the rest of the world, which represented around 0.8 per cent of GDP. After the FTA between the United States and Chile came into force in January 2004, Chilean suppliers obtained government procurement orders from the United States worth \$635,516 in 2004 and \$233,570 in 2005, compared to \$32,090 in 2003 (TWN, 2007). This is, no doubt, a huge increase, but from an almost negligible level.
- 18 These development provisions are contained notably in Articles IV and XIX (2) of the GATS, and in the Guidelines and the Procedures for the Negotiations on Trade in Services of March 2001.
- 19 In the positive list approach, countries commit to liberalize only in those areas and to the extent specified in the list, while in the negative list approach it is assumed that there is full liberalization in all sectors except those listed.
- 20 For an assessment of the development dimension of international investment agreements, see UNCTAD, 2003, Part Two).
- 21 In view of the claims under NAFTA, some FTAs and RTAs have clauses to limit investor protection from government (see UNCTAD, 2006a). The FTA between the United States and the Republic of Korea, for example, has a special annex (Annex 11-B) that aims at clarifying the criteria for indirect expropriation and excludes “appropriate” policy in certain important economic sectors from indirect appropriation.
- 22 For a discussion of the impact of international investment rules on options for national development policy, even under the softer conditions of multilateral agreements, see Cho and Dubash (2005).
- 23 See, for example, Chang, 2005; Correa, 2005 and 2006; Maskus, 1997; and Shadlen, 2005b.
- 24 The WTO TRIPS Agreement allows countries to exclude the patenting of plants and animals. However, FTAs involving the United States, such as the one signed by Chile, require the patenting of plants that are “new, involve an inventive step and [are] capable of industrial application”. TRIPS also allows countries to have a *sui generis* system of protection of plant varieties, while FTAs involving the United States require the partner countries to subscribe to the Convention for the Protection of New Varieties of Plants (revised in 1991), which provides strong intellectual property protection for plant varieties that may adversely affect the rights of small farmers in saving and exchanging seeds (Khor, 2007b). For more details on TRIPS and bilateral agreements, particularly with LDCs, see UNCTAD, 2007a.
- 25 Comparing United States, EU and Japanese competition legislation from a development perspective, Singh (2002) concludes that the kind of competition policy adopted by Japan in the 1950s and 1960s, when that country was at a similar level of development as many emerging market economies today, may be more suitable for most developing countries. At the time, Japanese competition legislation served as a tool to restrict the intrusion of large foreign firms and their products, on the one hand, and to nurture and strengthen Japanese firms so that they could develop and eventually successfully compete with those large foreign companies, on the other. The kind of model represented by the Japanese example, in which competition policy is complemented, if not subsumed, under industrial policy, would not be permitted in the kind of competition agreement propounded in today’s FTAs. Indeed, they would seek to outlaw the Japanese-style model that developing countries may find consistent with their development needs.
- 26 See also Ocampo and Taylor, 1998; Stiglitz, 1998, 2002; Rodrik, 2004, 2006; IMF/IEO, 2005; and World Bank, 2005b.
- 27 See, for instance, Kehoe, 2003.
- 28 See Preamble to NAFTA Agreement. The specific objectives of the Agreement are stated in its Article 102: “The objectives of this Agreement, as elaborated more specifically through its principles and rules, including national treatment, most-favoured-nation treatment and transparency, are to: (a) eliminate barriers to trade in, and facilitate the cross-border movement of, goods and services between the territories of the Parties; (b) promote conditions of fair competition in the free trade area; (c) increase substantially investment opportunities in the territories of the Parties; (d) provide adequate and ef-

- fective protection and enforcement of intellectual property rights in each Party’s territory; (e) create effective procedures for the implementation and application of this Agreement, for its joint administration and for the resolution of disputes; and (f) establish a framework for further trilateral, regional and multilateral cooperation to expand and enhance the benefits of this Agreement.”
- 29 Additional steps towards regional economic cooperation or integration inside NAFTA require the signature of new agreements. One such agreement is the Security and Prosperity Partnership of North America, which was launched in March 2005 as a trilateral effort to increase security and enhance prosperity. Its priorities are emergency management, addressing influenza pandemics, energy security, and safe and secure gateways (see Security and Prosperity Partnership of North America, at: www.spp.gov/). In 2001, the President of Mexico proposed a deepening of integration and the creation of a North American Community. This would include integration of infrastructure and transportation networks, the creation of a development fund to reduce income disparities among the member countries, the establishment of a North American Commission, a move towards a customs union and eventually a common currency, and forging a more humane immigration policy (Pastor, 2001). However, the other members did not follow-up on this proposal.
- 30 The NAFTA Secretariat comprises the Canadian, Mexican and United States sections, each a “mirror image” of the other. They are headed by secretaries, who, while appointed by their respective governments, function independently of them. The three secretaries work on a consensus basis, and report to the Free Trade Commission.
- 31 See, for instance, Hufbauer and Schott, 2005.
- 32 Recent discussions on the policy space limitations that developing countries face when entering into FTAs with developed countries can be found in Shadlen, 2005a; Khor, 2007a; and Oxfam, 2007. For a discussion on policy autonomy in the multilateral framework, see *TDR 2006*, chap. V.
- 33 For a case study on the investment provisions under NAFTA, see Leshner and Miroudot, 2006. UNCTAD (2006b) discusses how the NAFTA model on investment-related measures has been followed in many other bilateral and regional agreements.
- 34 According to Vivas-Eugui (2003: 7), “In NAFTA, TRIPS-plus standards include the extension of coverage (i.e. protection of plant varieties based on UPOV’s [International Union for the Protection of New Varieties of Plants] models or protection of program-carrying satellite signals) or limitations in flexibilities that were later agreed to at the international level in the TRIPS Agreement (i.e. causes for the revocation of patents are limited to cases where, for example, the granting of a compulsory license has not remedied the lack of exploitation of the patent)”. NAFTA also contains a more extensive application of the national treatment principle, higher standards of copyright protection and more restrictive provisions on compulsory licensing (Drahos, 2001).
- 35 In relation to intellectual property rights, the United States is going much farther than NAFTA in its demands in subsequent bilateral and regional agreements (Shadlen, 2005b).
- 36 On the other hand, the United States has lost importance as a source of Mexican imports. The share of imports from the United States in Mexico’s total imports fell from 71.5 per cent in 1990–1995 to 59.4 per cent in 2000–2005. This may be a sign of the loss of competitiveness of United States exports. On the other hand, trade with Canada has remained marginal for Mexico.
- 37 Pacheco-López and Thirlwall (2004) also discuss how Mexico’s economic development as a result of liberalization has been limited because of the balance-of-payments constraint.
- 38 See UNCTAD *Handbook of Statistics 2005*, table 4.2E.
- 39 The change in the definition of FDI in 1994 does not permit an accurate comparison between pre- and post-NAFTA periods (Pacheco-López, 2005).
- 40 For a more detailed analysis of the development of international production networks and its implications for developing countries, including Mexico, see *TDR 2002*. A case study of the Mexican automobile sector, the problem of its strong dependence on inputs from the United States and its current policy challenges is discussed in Mortimore and Barron (2005).
- 41 These authors highlight the high concentration of export-oriented manufacturing in a few industries. High concentration is also found at the level of firms, with no more than 300 firms accounting for the bulk of Mexico’s manufactured exports. Pacheco-López (2005) also reports that competition from the TNCs, along with the high import content of their export-oriented production, has increasingly driven domestic firms out of business.
- 42 *TDR 2003* (box 5.1) presents a more detailed examination of Mexico’s industrial structure for the period 1980–1998. It shows that in some sectors such as clothing, exports grew rapidly while domestic value added fell; in transport equipment, non-electrical machinery, electrical machinery and professional and scientific equipment, exports grew faster than value added. By contrast, in some other sectors that are not integrated into international production networks, growth in value added was strong but export performance was below average.
- 43 See also *TDR 2003*: 105–106; Moreno-Brid, Rivas Valdivia and Santamaría, 2005; and Cimoli et al., 2006.

- 44 Moreover, Moreno-Brid, Rivas Valdivia and Santamaría (2005) report that banking credit for productive activities as a proportion of GDP shrank by more than 15 per cent between 1996 and 2005.
- 45 At an average annual rate of 3 per cent a year between 1990 and 1999 (Sáinz, 2006).
- 46 Palma (2005) shows that even in the automobile sector, which was the most successful in terms of productivity, wages have stagnated.
- 47 For international comparison purposes, ECLAC figures on poverty differ from government figures, which were 52.5 per cent in 1994, declining to 47 per cent in 2005 (See Secretaría de Desarrollo Social, at: www.sedesol.gob.mx/).
- 48 Hanson (2003) discusses in some detail the increasing regional wage differences, as well as the rising inequality of wages between skilled and non-skilled workers. He also reports that there is little evidence of convergence in wages between Mexico and the United States.
- 49 Data on migration obtained from Giorguli, Gaspar and Leite, 2006; Hoefler, Rytina and Campbell, 2006; and United States Department of Homeland Security, *Yearbook of Immigration Statistics: 2006*, tables, at: www.dhs.gov/ximgtn/statistics/publications/LPR06.shtm. Data on remittances obtained from World Bank, *Remittances* database at: www.worldbank.org/.

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REGIONAL COOPERATION AND TRADE INTEGRATION AMONG DEVELOPING COUNTRIES

The main forces that have shaped the process of globalization over the past two decades have also dominated recent trends in regional integration. The tendency to give priority to market forces in determining factor allocation is reflected in the rapidly increasing number of regional and bilateral free trade agreements (FTAs) or preferential trade agreements (PTAs) discussed in chapter III. There have been few initiatives to strengthen proactive national policies that focus on creating conditions favourable to capital formation, industrialization and structural change compared to initiatives for pushing trade and investment liberalization further than what has been achieved at the multilateral level.

Notwithstanding this evolution towards preferential North-South agreements, intraregional trade in a number of regional blocs of developing countries has been growing faster than their trade with countries in other regions. Moreover, the composition of intraregional trade suggests an important potential for export diversification, and thus for accelerating industrial development.

Intraregional trade in a number of regional blocs of developing countries has been growing faster than their extraregional trade.

This chapter first provides an overview of the basic concepts and forms of regional economic integration, followed by an assessment of regional integration processes and recent regional cooperation initiatives from a development perspective, including the different institutional forms of such cooperation. Sections B and C then turn to regional trade experiences in developing countries and economies in transition. They take a closer look at the extent to which intraregional trade, through its specific characteristics, could foster industrial development, which for most developing countries is the main vehicle for catching up with the more advanced economies. It is shown that the total value and the product composition of intraregional trade, depends on several factors. A formal trade integration agreement is one of these factors, but other factors, including macroeconomic and structural conditions and additional areas of regional cooperation, can be as or even more important. Section D concludes, highlighting South-South regional trade cooperation as a complementary vehicle for moving towards greater integration into the world economy.

A. Forms of regional cooperation and effective trade integration

Regional economic cooperation is primarily associated with trade agreements. These may involve the granting of tariff preferences, free trade commitments, or the creation of customs unions. More advanced forms of regional cooperation are the creation of common markets or economic unions, where formal cooperation extends into other areas, such as the movement of capital and persons and macroeconomic and sectoral policies. Within a tariff preference arrangement, contracting parties grant lower tariff rates to products originating in the partner country (or countries) than for products originating in the rest of the world. A free trade agreement goes further, since it eliminates “the duties and other restrictive regulations of commerce (...) on substantially all the trade between the constituent territories in products originating in such territories” (GATT, Article XXIV (8) (b)). Contracting countries constitute a customs union if, in addition, they apply “substantially the same duties and other regulations of commerce” to the trade with countries that are not part of the union (GATT, Article XXIV (8) (a)). Advancing along the road towards formal economic integration is the common market, which adds to the previously mentioned provisions the free movement of labour and capital among the participants. Finally, an economic union is achieved when members also harmonize their economic policies (table 4.1).

Each of these integration steps entails deeper commitments by participants, and requires higher levels of policy coordination. Moreover, in the course of an integration process, countries may

have to transfer part of their national sovereignty in policy-making to institutions at the regional level. In a customs union, countries give up the right to set their individual import tariffs, and any modification is negotiated within the framework of regional institutions. Furthermore, members of a customs union or a common market need to coordinate other aspects of their economic policy, such as their monetary policy, exchange rates, various elements of fiscal policy and sectoral programmes, in order to avoid asymmetries and tensions among them that could jeopardize the regional agreement. For instance, volatile exchange rates between the currencies of a region with intense intraregional trade and strong financial relations may lead a country with an appreciating currency to resort to defensive trade measures vis-à-vis its intraregional partners. Similarly, if one of the members of a customs union tries to attract FDI by offering tax advantages or a loose environmental regulatory regime, it may trigger a “race to the bottom” in taxation and environmental standards, which would harm all the members of the union. Also, certain instruments of industrial policy may be applied at the regional level in order to maximize the potential gains from a wider market; at the very least, national incentives to industries may be harmonized in order to avoid unfair competition within the region and defensive reactions that would hinder intraregional trade (see chap. VI, sect. C). Finally, member countries may address economic asymmetries and inequalities within the region through coordinated policies and common tools, such as structural funds aimed at reducing economic and social disparities.

Table 4.1

MAIN CHARACTERISTICS OF DIFFERENT TYPES OF TRADE INTEGRATION ARRANGEMENTS

	<i>Reduction of tariffs in intraregional trade</i>	<i>Elimination of tariffs in intraregional trade</i>	<i>Common tariffs for the rest of the world</i>	<i>Free factor mobility</i>	<i>Harmonization of economic policies</i>
Preferential trade agreement	Yes				
Free trade agreement		Yes			
Customs union		Yes	Yes		Coordination desirable
Common market		Yes	Yes	Yes	Coordination desirable
Economic union		Yes	Yes	Yes	Yes

Source: UNCTAD secretariat.

As a result, regional cooperation agreements that go beyond the reduction of legal trade barriers tend to progressively incorporate elements that, although trade-related, have a much broader impact on economic stability and development, such as monetary, fiscal and sectoral policies. In the case of common markets, this may include rules relating to migration and capital movements. In parallel, regions may have to develop some supranational institutions for managing the different aspects of integration, which may be quite diverse depending on the stage of development, the political circumstances and existing national institutions. In an economic and monetary union, member States formally give up national sovereignty over monetary and exchange-rate management, as a regional central bank assumes control over a common monetary policy and a common currency.

Early regional cooperation agreements, which were concluded mainly by countries at similar levels of development, shared common and closely interlinked political and economic objectives. These agreements typically had ambitious aims with regard to the degree of integration, often going well beyond those of preferential agreements or FTAs. This was the case, for instance, with the Southern African Customs Union (1910), the European Economic Community (1958), the Central American Common Market (1961), the Andean Pact (1969) and the Economic Community of West

African States (1975).¹ In some cases, complete economic union was the explicit ultimate goal.

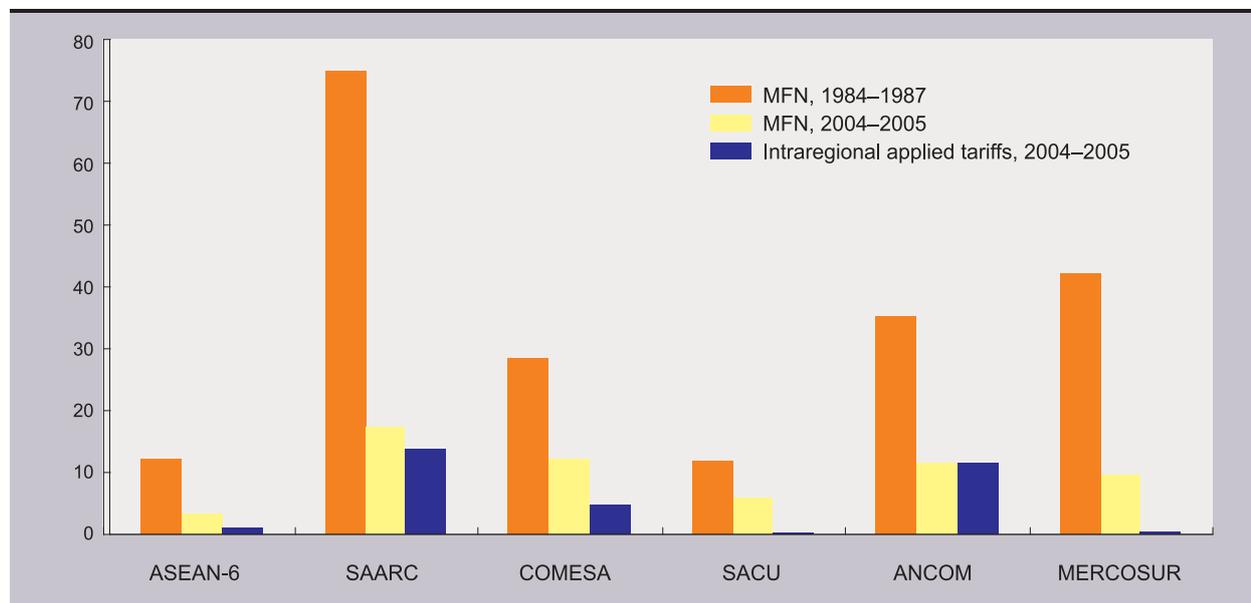
The attitude of developing countries towards regional integration has evolved with their situation in the global economy, their experiences with globalization, and, in some cases, with their changing development strategies. Traditionally, trade preferences, mainly in the form of lower (or zero) import tariffs, were a key instrument for enlarging product markets and intensifying industrial linkages. This was based on the assumption that a larger regional market would increase opportunities for industrial specialization and the achievement of scale economies in an otherwise protectionist international environment. With the progress achieved in multilateral trade liberalization, and the substantial reduction of most-favoured-nation (MFN) tariffs over the past 20 years, the potential for such preferences to advance regional integration has diminished (fig. 4.1). Moreover, as discussed in chapter III, the conclusion of a number of North-South trade agreements has further weakened the potential benefits of regional preferences.

This does not mean, however, that preferential access among regional parties has lost all its relevance; it may still be an important tool for accelerating intraregional trade and industrial integration within a region, even if it may not be sufficient by itself to advance the processes of

Figure 4.1

TRADE-WEIGHTED TARIFFS IN SELECTED REGIONAL AGREEMENTS

(Per cent)



Source: UNCTAD secretariat calculations, based on UNCTAD, *TRAINS* database; UNCTAD, 1994; and 2007a.

Note: Due to incomplete data, MFN tariffs for COMESA are estimated on the basis of the tariffs of Burundi, the Democratic Republic of the Congo, Ethiopia, Kenya, Madagascar, Malawi, Mauritius and Sudan; MFN tariffs are thus not entirely comparable to the intraregional applied tariffs. MFN tariffs for SACU in the period 1984–1987 are those of 1988.

industrialization and diversification. In most cases, this will also require a supportive environment of fast output growth and appropriate industrial and macroeconomic policy measures. Regional tariffs could still be an important means of supporting sectoral policies, even if the average import tariffs remains relatively low (*TDR 2006*: 174–179). Indeed, relatively high tariffs on specified products have served to promote specific activities, such as the automobile industry, in some regional arrangements.² But post-war West European integration and the East and South-East Asian experience with regional integration both show that a macroeconomic environment that is favourable for capital accumulation and strong industry-driven growth can be as important for unleashing a regional integration dynamic.

Indeed, trade liberalization was not the driving force behind either post-war European integration or the more recent East and South-East Asian experiences. In both cases, sustained peri-

ods of very high growth, driven by a multiplicity of interdependent factors, but including high rates of capital formation, provided the context in which various economic thresholds linked to industrial development were crossed and integration could proceed in a reasonably smooth and measured manner (Sodersten, 1970: 442; ADB, 2006). In both cases too, strong States were key to integration among neighbouring countries, and the basis on which convergence and regional integration were able to progress in a measured and relatively stable manner. From the mid-1950s, an accelerating pace of European integration reflected the very rapid post-war recovery, the high level of economic and industrial development already reached and the relatively small economic and social gaps between neighbouring countries. When intra-European FDI finally took off in the 1960s, having lagged behind the rise of European inter-industry and intra-industry trade, it was concentrated in high-technology and information-intensive sectors that were characterized by increasing returns and growing high-

wage sectors, tacit knowledge and spillovers (Dunning, 1984: 96–99). By the mid-1970s, the shedding of manufacturing jobs associated with “positive deindustrialization” in the more advanced economies (Rowthorn and Wells, 1986), provided room for the new and less advanced members to build their own investment-export nexus around closer regional ties, perhaps best demonstrated by the very rapid growth and convergence of Ireland. This pattern is more difficult to detect in most of the subsequent regional arrangements, including in the recently enlarged EU itself, where the income gap between the new and old members is considerably wider than in the original grouping, in some instances resembling more of a North-South divide. A similar situation is found in North America, when long-standing intra-industry trade and FDI flows between Canada and the United States were extended south under NAFTA. However, the economic gap in this case is greater still, and in the absence of institutional mechanisms that might support the convergence process, the integration pattern has been hesitant and fragmented, although very advanced in some key industries, such as automobiles (Mortimore, 1998).

The pattern of development and integration in East and South-East Asia has resembled some of the features of European integration, but with distinct characteristics due to the influences and legacies of colonial rule, the economic gap between Japan and its neighbours, and the specific demands of late industrialization. Here, the integration process may have followed a more sequenced path, linking stages of industrialization with regional development. In this process, the leading economies upgraded their economic activity to more and more sophisticated manufactures thus opening up opportunities for their less developed neighbours to enter into a regional division of labour by increasing their resource-based and labour-intensive industries that could no longer be competitively supplied by the front runners. This “flying geese” pattern, enabled trade and FDI to serve as vehicles for “recycling” comparative advantage; and, beginning with post-war Japan, there was a deliberate use of pro-investment macroeconomic policies

along with strategic industrial and technology policies (Sakakibara and Yamakawa, 2003). More recently, since the early 1990s, China has increasingly contributed to shaping the pattern of regional integration in East and South-East Asia.

Until the end of the 1990s, China was not a member of any regional free trade or economic cooperation arrangement except the Asia-Pacific Economic Cooperation (APEC) forum, nor did it have any bilateral free trade or investment agreement. Thus the Chinese proposal for a free trade area with

Preferential access among regional members may still be an important tool for accelerating intraregional trade and industrial integration.

the Association of Southeast Asian Nations (ASEAN) in November 2000 marked a policy shift by its Government to embark on regionalism as a complement to its global external economic relations. Despite the absence of formal regional agreements, economic integration between China and other Asian economies, particularly in East and South-East Asia,

had been close due to an investment and trade nexus driven mainly by multinational companies. The emergence of China as an FDI destination because of its low production costs – which are even lower than those prevailing in ASEAN countries – first attracted Chinese investors from Hong Kong (China), Taiwan Province of China and other Asian countries. When companies from Taiwan Province of China, in particular, accelerated production relocation to the mainland, companies from Japan and the Republic of Korea began a strong push to sell to China. This was followed by a rapid increase in FDI from these two countries with China’s potential as an important market becoming apparent. By the end of 2006, Japan had become the second largest source country of FDI in China, while the Republic of Korea was the fourth largest, and China accounted for 40 per cent of the latter’s total FDI.³ ASEAN countries also increasingly invested in China. Over the years, China has increasingly taken on processing and assembly operations, thus becoming an export platform for many transnational corporations (TNCs).

Trade policy has played an important role in the steep rise of China’s imports and exports. Tax and tariff exemptions for imports destined for processing have been a large incentive for foreign

investors to develop processing facilities in China. As a result, much of the FDI to China has been trade-related, targeting production for export or re-export. The cumulative effect of FDI on China's exports has been significant: by 2005, 60 per cent of its exports originated from foreign-funded companies in China, and processed goods comprised 60 per cent of its total trade. At the same time China's imports from ASEAN have also shifted from primary products to manufactured products (e.g. electrical and electronic machinery and mechanical appliances), which amount to about 50 per cent of its total imports from ASEAN.⁴

This might be due to increasing intra-industry trade in manufactured products between members of ASEAN and China. Accordingly, China's trade balance with ASEAN turned from a surplus to a deficit in 1992, and this has been growing ever since, while it has had a rising surplus in its trade balance with the rest of the world.

To sum up, trade and investment flows within East and South-East Asia have been shaped largely by two countries: Japan and China. And even though they are not members of ASEAN, they have played a crucial role in extending and deepening regional integration within that bloc. Beginning in the early 1980s Japanese corporations, saw their market shares threatened by persistent appreciations of the yen and a growing number of trade disputes, which they sought to circumvent partly by relocating their production to their regional neighbours. The strong interdependence between Japanese FDI and intraregional trade flows turned ASEAN into an integrated pro-

duction and trading region until the middle of the 1990s. The largest proportion of manufactured goods, particularly IT products, were traded within and between Japanese TNCs, and international competitiveness and an increase in overseas market shares became the major motives for Japanese investments at home and within ASEAN. In the first half of the 1990s, China emerged as an important regional power. Its growing imports from ASEAN countries gave a boost to those economies and further strengthened intraregional trade flows and the competitiveness of its final export products in the international production chain. Thus

the Asian experience shows that in certain circumstances regional trade integration does not necessarily require full-scale formal cooperation; it can also be accelerated by corporate decisions in an appropriate macroeconomic and trading environment.

Efforts aimed at closer regional integration among developing countries in other regions have met with less favourable conditions and have

been hindered by recurrent financial and economic crises, as in Latin America; or by slow growth and persistent dependence on the production and exports of primary commodities, as in Africa. Even if cross-border industrial linkages are far less pronounced than in other parts of the world, intraregional trade has increased in many regions, and in many cases has considerable potential to support the development process. The following section takes a closer look at the different integration experiences in some developing regions and economies in transition.

Closer regional integration in Latin America has been hindered by recurrent financial and economic crises, and in Africa by slow growth and persistent dependence on the production and export of primary commodities.

B. The relative importance of trade flows in regional integration among developing countries

1. *Measures of regional trade integration*

Despite the erosion of regional tariff preferences, in general, intraregional trade among developing countries has continued to expand over the past 20 years, not only in absolute terms but also compared to extraregional trade. This is true both for geographical regions and for regional cooperation arrangements. In Africa, Latin America and, particularly, in East and South-East Asia, the share of intraregional trade in total trade has increased since the mid-1980s, despite faster trade liberalization at the global level. In East and South-East Asia, intraregional trade accounts for more than 40 per cent of total trade (fig. 4.2A), while in Latin America it has fluctuated between 15 and 20 per cent of the region's total trade since the 1970s. However, this is heavily influenced by Mexico, whose trade – mainly with Canada and the United States – represents more than 40 per cent of the regional total, twice as much as in the 1980s. If Mexico is excluded, the share of Latin American intraregional trade has grown significantly since the late 1980s, to account for about one quarter of its total trade. In Africa, the share of intraregional trade has also increased since the mid-1980s, albeit more slowly and at a lower level, from less than 5 per cent to close to 10 per cent of total trade.

Another indicator showing how much the regional factor may influence the direction of trade is the trade intensity index, which compares the

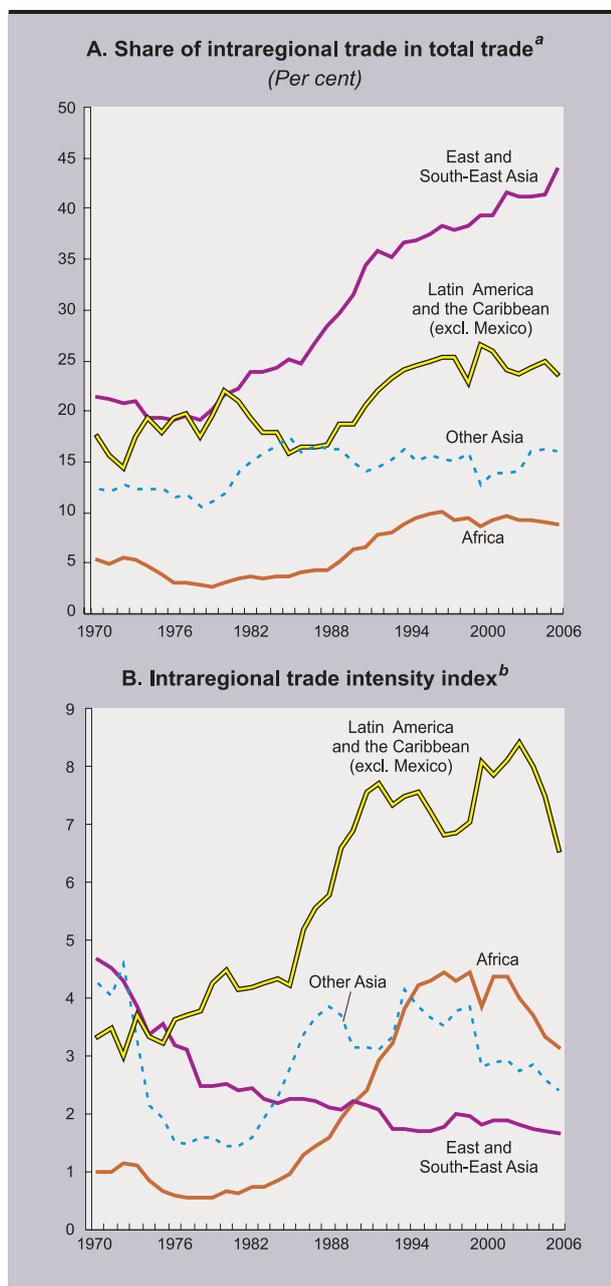
share of intraregional trade with the relative importance of that region in global trade. The value of this index is 1 when the share of intraregional trade of a region's total trade is equivalent to the share of the region's total trade in world trade. In this case there is no geographical bias in the trade relations of the countries belonging to that region. The more this index exceeds unity, the stronger is the regional bias in external trade (fig. 4.2B).

On this measure, there is a regional bias in all geographical regions. It is the strongest in Latin America, excluding Mexico, where it has also increased the fastest since the 1980s; although it has fallen since 2003 under the impact of rising prices of primary commodities exported by Latin American countries to destinations outside the region. In East and South-East Asia, this index followed a declining trend from the early 1970s to the mid-1990s, and since then it has remained stable at a relatively low level. This is because the sharp increase in intraregional trade has been accompanied by an equally strong growth in the share of that region's trade in global trade. In Africa, intraregional trade intensity has grown significantly since the mid-1980s, although from very low levels, reflecting both the expansion of intraregional trade and the relative stagnation in total African trade. As in Latin America, the recent fall of the trade intensity index in Africa is mainly the result of commodity price developments.

The growing relative importance of intraregional trade in all developing regions over the past 20 years, despite the broad trend towards globali-

Figure 4.2

INTRAREGIONAL TRADE INDICATORS FOR SELECTED DEVELOPING REGIONS, 1970–2006



Source: UNCTAD secretariat calculations, based on IMF, *Direction of Trade Statistics* database; and UNCTAD *Handbook of Statistics* database.

a $\frac{X_{AA} + M_{AA}}{X_A + M_A}$, where X_{AA} and M_{AA} are intraregional exports and imports of region A, and X_A and M_A are total exports and imports of region A.

b $\frac{X_{AA} + M_{AA}}{X_A + M_A} \div \frac{X_A + M_A}{X_W + M_W - (X_A + M_A)}$, where X_W and M_W are world exports and imports.

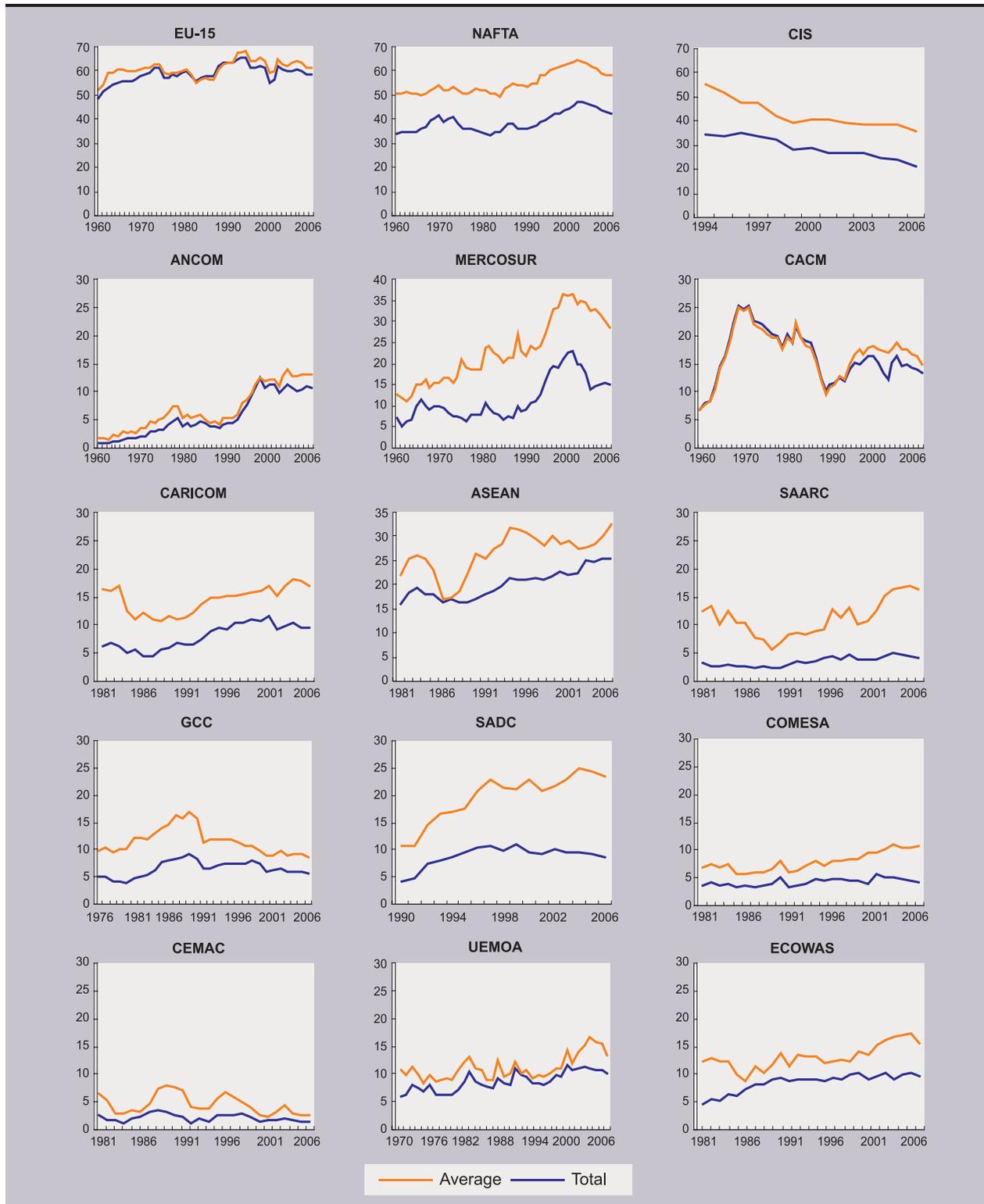
zation and the reduction of trade barriers at the global level, confirms the important role of de facto trade-related advantages stemming from geographical proximity, lower transaction costs, and tacit knowledge owing to repeated interaction or cultural and historical affinity (Rosenthal and Strange, 2004).

The volume of intraregional trade varies considerably among different formal regional blocs, corresponding roughly to the stage of development of their member States in terms of per capita income and degree of industrialization. For instance, intraregional trade is very significant within the EU and NAFTA, where it represented 60 per cent and 45 per cent, respectively, of total trade during the period 2000–2006. In the Commonwealth of Independent States (CIS), intraregional trade declined for much of the 1990s as the member States underwent a serious adjustment crisis, but it is still significant, accounting for 25 per cent of the region's total trade in 2000–2006.

Figure 4.3 shows the evolution of intraregional trade in selected regional agreements,⁵ using two indicators: the *total share* of intraregional trade, which is obtained by comparing the aggregate intraregional trade to the aggregate total trade of the group of countries; and the *average share* of intraregional trade, which is the simple average of each country's share of intraregional trade. The combination of the two measures is indicative of the degree of heterogeneity of each bloc. In regional agreements involving partners of very different economic size, the first indicator is strongly influenced by the geographical trade patterns of the larger member States; however, the relative importance of the members of a regional agreement as markets and as suppliers of goods may vary considerably among participants, and tends to be greater for smaller economies. In such cases, the second indicator (simple average) will show a higher level of intraregional trade than the first (aggregate share). This is clearly the case in MERCOSUR, the South Asian Association for Regional Cooperation (SAARC) and the Southern African Development Community (SADC). The difference is also significant in NAFTA and the CIS, where the share of intraregional trade is considerably higher for the smaller member countries. For instance, in 2006, United States trade with NAFTA partners accounted for 30 per cent

Figure 4.3

SHARE OF INTRAREGIONAL TRADE IN TOTAL TRADE: SELECTED REGIONAL BLOCS

(Total for the bloc and unweighted average of individual countries in per cent)

Source: UNCTAD secretariat calculations, based on IMF, *Direction of Trade Statistics* database.

Note: The periods differ, depending on availability of comparable data.

of its total trade, while that proportion exceeded 70 per cent for Canada and Mexico. Similarly, trade with other CIS members represented only 11 per cent of the entire trade of the Russian Federation, but nearly 40 per cent, on average, of the total trade of the other CIS countries.

2. Latin America and the Caribbean

Among the four initial members of MERCOSUR, Argentina, Brazil, Paraguay and Uruguay,⁶ intraregional trade grew rapidly between 1990 and 1998, not only as a result of the process of integration itself, but also because during this period demand for imports rapidly increased as Latin America emerged from the debt crisis of the 1980s. MERCOSUR countries, especially Argentina and Brazil, have a diversified export structure, owing to their relatively advanced industrial development. As a consequence, they have been able to respond to the expanding domestic demand of regional partners in a large variety of goods. However, as economic crises struck the region again between 1999 and 2002, imports of MERCOSUR countries fell and intraregional exports plummeted, while the level of their exports to the rest of the world remained roughly the same. These developments are reflected in the pattern of intraregional exports: their share in the region's total exports initially jumped from 8.9 per cent in 1990 to 25.0 per cent in 1998, and then contracted to 11.5 per cent in 2002. With the subsequent economic recovery, intraregional exports expanded more rapidly than overall exports. The share of intraregional imports has been more stable, at around 20 per cent, since intra- and extraregional imports have expanded and contracted in parallel. The overall share of intraregional trade in the region's total trade, of about 15 per cent in 2005–2006, is still lower than it was in the late 1990s. Of the MERCOSUR members, Brazil, whose trade represents 70 per cent of the region's total trade, has a relatively low share of intraregional trade (10 per cent), whereas for the other member countries, MERCOSUR is the most important trading partner.

In the Andean Community of Nations (ANCOM), the share of intraregional trade is

lower than in MERCOSUR, although it has been increasing since the early 1990s. This is largely due to the weight of primary commodities in these countries' exports, which go mainly to developed countries. In the case of the Bolivarian Republic of Venezuela – whose exports are dominated by oil and account for roughly half of total ANCOM exports – less than 5 per cent of the country's total exports were directed to other ANCOM countries by 2006. On the other hand, one fifth of Colombia's exports, which are more diversified, go to other ANCOM partners. As in MERCOSUR, the share of intraregional imports is more significant than that of intraregional exports. A significant and growing share of ANCOM countries' trade is with other Latin American countries: it reached about 30 per cent of total ANCOM trade in 2000–2006. This indicates that a wider regional agreement (such as the proposed Union of the South involving all South American countries) would already be able to count on considerable trade among the members.

In the Central American Common Market (CACM), one of the earliest regional cooperation initiatives among developing countries, the trade agreement of 1961 gave a considerable boost to intraregional trade, which surged from 7 per cent of total trade in 1960 to 25 per cent in 1968–1970. The rationale for the agreement among its five small members was to create a wider market for their manufacturing industries. The strategy was successful inasmuch as the share of manufactures in the region's GDP rose from 14 to 18 per cent during the 1960s (ECLAC, 2005). The relative decline of intraregional trade in the 1980s was due to a prolonged recession as a result of the debt crisis, as well as to regional conflicts. Moreover, some CACM members were dissatisfied with what they considered an uneven distribution of the costs and benefits of the common market. As a consequence, Honduras left the group in the late 1970s and reinstated customs tariffs on imports from its former partners, and Costa Rica and Nicaragua imposed new barriers on imports from other CACM members (Déniz Espinós, 2006). Although economic and political conditions once again became more favourable for intraregional trade in the 1990s, and Honduras rejoined the CACM, intraregional trade as a share of total trade did not fully recover, remaining at about 15 per cent of total trade. This was not least because, meanwhile, the group's members had strengthened their trade

relations with the United States, which led to the creation of the Central American Free Trade Association (CAFTA).⁷

3. Developing Asia

Of all regional cooperation agreements among developing countries, ASEAN has the highest share of intraregional trade in its total trade: 33 and 26 per cent by simple and weighted averages respectively (fig. 4.3). Although ASEAN was created as a political rather than an economic grouping, trade among its participants has consistently increased since the mid-1970s. Trade liberalization was formalized only in 1992 with the launching of the ASEAN Free Trade Area (AFTA). Trade expansion in ASEAN was largely due to the links of the member States with other economies in East and South-East Asia. Strong regional integration began in the mid-1980s when, under a combination of macroeconomic and structural pressures (Akyüz, 1998), Japanese FDI flows to East Asia started to grow. Vertical production relations in the electronics industry, especially from the beginning of the 1990s, became a more prominent feature of regional integration, involving also the second-tier NIEs and China. The strong growth in the volume of intraregional trade, largely through intra-industry trade in intermediate goods since the late 1980s, combined with intraregional FDI flows, has been an important feature of the East Asian experience over the past two decades; but reliance on markets for final goods outside the region has also continued unabated (Sakakibara and Yamakawa, 2003).

These trends are connected with the rise of regional production networks. As discussed in previous *TDRs* these networks involve large TNCs which produce a standardized set of goods in several locations, or groups of small and medium-sized enterprises that are located in different countries and linked through international subcontracting to a lead coordinating firm. Both types of networks

exist in East Asia, though the first kind is more prevalent. China has contributed significantly to the accelerating pace of intraregional trade since the late 1980s, with large firms from the region relocating assembly operations to take advantage of cost conditions. These firms have become important exporters of intermediate goods to China. Participation in these networks has also been part of the development impetus in South-East Asia, albeit confined to a small number of industries.

Regional production networks have emerged mainly in the electrical and electronics industries and, in the context of fast output growth in East and South-East Asia have contributed to the rapid expansion of intraregional trade. In 2006, the trade of ASEAN members with other developing countries in East and South-East Asia accounted for almost 50 per cent of total ASEAN trade, compared to 30 per cent in 1990. This dynamic shows how trade flows may be driven not only by formal agreements, but also by de facto regional production networks. Its success has encouraged negotiations for the establishment of a free trade area that would include ASEAN countries, China, the Republic of Korea and Japan.

In East and South-East Asia, strong growth in intraregional trade is connected with the rise of regional production networks.

Outside East and South-East Asia, the experience with production networks is more problematic, particularly where FDI has been attracted against a backdrop of weak (or even declining) domestic capital formation and, in some instances, even “deindustrialization”. In the absence of strong internal integration, FDI can lead to a dualistic development pattern based on enclave type development.⁸ There is also the added danger of it leading to an overproduction of standardized products with a high import content, as in the assembly industries, which threatens to lock countries into low-wage, low value-added activities characterized by diminishing returns and a large informal sector.

Similar to the impact of the crises in Latin American countries that affected the integration process in MERCOSUR, the Asian financial crisis in 1997–1998 led to a fall in intraregional exports in East and South-East Asia in general, and in ASEAN in particular. However, the impact in

ASEAN was less severe, and the Asian economies as well as their intraregional trade flows recovered more quickly. In ASEAN, intraregional exports fell by 20 per cent between 1996 and 1998, compared to 50 per cent in MERCOSUR between 1998 and 2002. The main reason for the weaker impact of the crisis is that much of the trade between ASEAN countries is composed of intermediate goods whose final destination, after being transformed, is outside the region. Thus the resilience of the final demand maintained the intraregional trade in parts and components.

Regional integration is much less dynamic in South Asia, where the establishment of the South Asian Association for Regional Cooperation (SAARC) in 1985 has not been followed by fast growth in intraregional trade, which in aggregate terms does not exceed 5 per cent of the region's total trade. This very limited intraregional trade is mainly because trade relations of the largest economies in the region, India and Pakistan, with the other members, and particularly with each other, are of minor importance compared to their extraregional trade. Nevertheless, SAARC countries, especially India, are important trading partners for the smaller members of the bloc.⁹ These asymmetries explain the gap between the two measures of intraregional trade shown in figure 4.3, with very low total intraregional trade but a significant average indicator for the countries.

In the countries that form the Gulf Cooperation Council (GCC), established as a customs union in 2003 to strengthen economic linkages and to increase the contribution of the industrial sector to their gross national product, the share of intraregional in total trade has remained modest mainly because the exports of all the members are dominated by fuels. The share of intraregional imports in total imports of the members is more significant, especially for Bahrain and Oman, and to a lesser extent Kuwait and Qatar. These imports consist mainly of manufactures from Saudi Arabia and the United Arab Emirates. The recent surge in the GCC countries' value of exports due to high oil prices has further reduced the share of intraregional trade in total trade, although intraregional

trade in GCC has expanded in absolute terms, with two-thirds of this expansion due to trade in manufactures. In the long run a sustained improvement in intraregional manufacturing trade could help GCC countries in their efforts to diversify their economies (Fasano and Iqbal, 2003).

4. Africa

African countries typically belong to several RTAs (fig. 4.4), but this has not always been accompanied by significant intraregional trade. Trade within the Arab Maghreb Union (UMA), the Economic and Monetary Community of Central Africa (CEMAC) and the Common Market for Eastern and Southern Africa (COMESA) has not exceeded 5 per cent of their total trade. Intraregional trade in UMA is particularly low, despite the relatively diversified manufactured exports of some of its members (Morocco and Tunisia). In 2005, Western Europe accounted for two thirds of total UMA exports: not only most of the fuel exports (mainly from Algeria and Libya) went to that market, but also 80 per cent of the manufactures exported by Morocco and Tunisia.

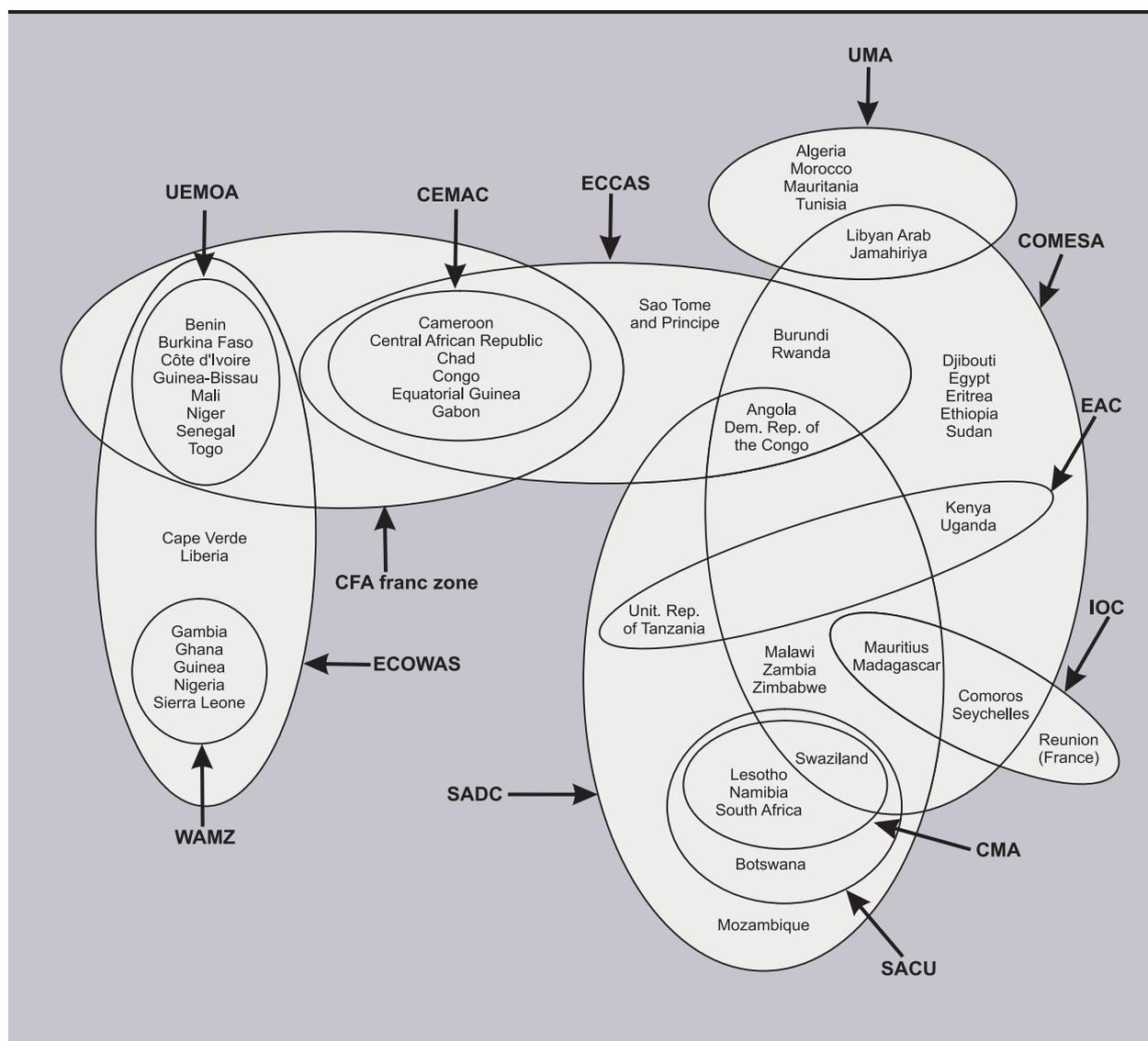
Trade flows may be driven not only by formal agreements, but also by de facto regional production networks.

The Economic and Monetary Community of Central Africa (CEMAC) displays the lowest intraregional trade share of all regional integration schemes in Africa (less than 2 per cent), mainly because five of the six CEMAC members (Cameroon, Chad, Congo, Equatorial Guinea and Gabon) rely mainly on exports of oil to the rest of the world. Cameroon was the only member to export more than 1 per cent of its goods and services to other CEMAC countries during the period 2003–2006. Intraregional imports are significant in the two landlocked countries of this bloc, the Central African Republic and Chad, accounting for between 11 and 17 per cent of their imports during this period, most of which originated in Cameroon.

Trade links between the members of the West African Economic and Monetary Union (UEMOA) are much more developed. Together with CEMAC

Figure 4.4

AFRICA: OVERLAPPING MEMBERSHIP IN REGIONAL INTEGRATION GROUPS



Source: UNCTAD secretariat, based on Tsangarides, Ewencyk and Hulej, 2006: 26.

Note: Comoros is also a member of the CFA franc zone.

and Comoros, this Union belongs to the CFA franc zone. UEMOA is also part of the larger ECOWAS (fig. 4.4) and intraregional trade in both these groupings during the period 2003–2006 accounted for around 10 per cent of total trade. Although CEMAC and UEMOA are part of the same monetary zone (see chap. V) and thereby exchange-rate risk is ruled out, trade between them is almost non-existent. By contrast, UEMOA has relatively strong trade links with the other countries form-

ing ECOWAS as well as with other subregions in Africa. In 2006, 26 per cent of UEMOA's exports went to ECOWAS and 32 per cent to Africa as a whole, while 20 per cent of its imports originated from ECOWAS and 23 per cent from Africa.

Trade integration in ECOWAS has advanced very slowly since the early 1990s and intraregional trade has been highly concentrated in a few countries. Three countries (Nigeria, Côte d'Ivoire and

Senegal) account for almost 90 per cent of all intraregional exports, and for almost 50 per cent of all intraregional imports. The relatively low intraregional trade in ECOWAS is partly due to the small share of Nigeria intraregional trade, considering that the country accounts for 75 per cent of total ECOWAS exports and 45 per cent of its imports. If Nigeria is excluded, intraregional trade increases to 20 per cent of total trade. Still, this average conceals wide differences among the member countries. Intraregional trade is substantially above average for landlocked countries such as Burkina Faso, Mali and Niger, and also for Senegal and Togo that supply the region with a few manufactures.

The relatively low level of intraregional trade in ECOWAS is also explained by the high dependence of most member countries on exports of primary commodities, and by a trade liberalization scheme that has very strict rules of origin. Access to the regional market is especially difficult for those firms and sectors that are at an early stage of development, given the low degree of internal integration. Such firms have to rely on imported inputs, and the content of domestic value added in their products is often too small to satisfy the rules of origin. In early 2000, only 17 manufacturing firms were able to comply with these rules (Shams, 2003). Other obstacles to intraregional trade are bureaucratic and physical ones, such as road charges, transit fees and administrative delays at borders and ports, which raise transport costs and render deliveries unreliable.

Intraregional trade is more important in the Southern African Development Community (SADC), and especially among the more limited number of members of SACU within that Community, which have close trade links with the largest member of the group, South Africa. The discrepancy between the two trends for SADC in figure 4.3 confirms the relatively greater importance of intraregional trade for the smaller countries of these RTAs.¹⁰ Angola, the second largest economy after South Africa within SADC has practically no trade relations with other African countries: its manufactured imports come almost exclusively from de-

veloped countries and Asian developing countries, and only a small fraction of its exports, almost exclusively crude oil, are exported to other African countries where refining capacities are either absent or very limited. However, for some SADC countries, in particular Malawi, Mozambique, Zambia and Zimbabwe, SADC is the major source of their imports, and it also accounts for 22 per cent, 16 per cent, 36 per cent and 45 per cent, respectively, of their total exports in 2005–2006.¹¹

In sum, the relatively small weight of intraregional trade in Africa, despite the existence of several (and frequently overlapping) RTAs, is due largely to their structure of production and the composition of their exports. As many countries are still specialized in a small number of primary commodities, while most of their imports consist of manufactures, the potential for intraregional trade is limited. The export-oriented production of labour-intensive manufactures in some countries, such as Cape Verde, Lesotho, Mauritius, Morocco and Tunisia is directed primarily to the European and United States markets. However, intraregional trade is significant for several relatively small economies, particularly the landlocked countries.

5. Commonwealth of Independent States (CIS)

In contrast to most regional groupings in Africa, Asia and Latin America, which have experienced an increase in intraregional trade over the past two decades, the experience of the CIS during the 1990s was one of economic disintegration, despite the conclusion of numerous agreements.¹² With the break-up of the Soviet Union, a formerly well-integrated economic space lost the basic elements for its functioning: a high degree of protection vis-à-vis the rest of the world, a single currency and central production planning that also determined the geographic location of production. This was accompanied by a sharp fall in total GDP, which was the most pronounced in the manufac-

Intraregional trade among the members of the CIS has been declining, despite numerous regional agreements.

turing sector and in agriculture. The result was a decline in trade flows between the newly independent States, and a reorientation of trade towards other regions, especially Western Europe. While intra-Soviet trade in 1990 accounted for 77 per cent of the total trade of the Soviet Republics, the share of intra-CIS trade in total CIS trade fell to 34 per cent by 1994 and to 21 per cent in 2006 (Elborgh-Woytek, 2003).¹³

The declining share of intra-CIS trade was accompanied by a dramatic decline in total external trade at the beginning of the 1990s. Between 1991 and 1993, total exports and imports of CIS members fell by 65 per cent and 72 per cent respectively. Since then, trade volumes have been rising; after a new setback to trade expansion as a result of the rouble crisis of 1998, exports have recovered since the start of the new millennium. In recent years, most CIS countries have seen their exports surge, mainly due to price increases in their primary commodity exports. Since 2000, the CIS has been one of the fastest growing regions in the world, with all members posting solid GDP growth rates.

The geographic distribution of the trade of CIS members varies widely. Some remain fairly dependent on intra-CIS trade, both in terms of exports and imports: for Belarus, Turkmenistan, Tajikistan, Uzbekistan, the Republic of Moldova and Ukraine, more than one third of total trade still takes place with other CIS partners; but for the Russian Federation, intraregional trade represented less than 12 per cent of its total trade in 2006. In general, CIS members depend more heavily on their region for imports than for exports.¹⁴

Until the mid-1990s, the largest economy in the region, the Russian Federation, remained the main trading partner for most CIS members, but by 2005 it was the main trading partner only for

Belarus, Ukraine and Uzbekistan. For several CIS members, it was replaced by the EU-15, while Kyrgyzstan's trade is mainly with China and Turkmenistan's is with Ukraine. Geographical proximity is playing an important role in determining the direction of trade of the different CIS members. Thus, the Islamic Republic of Iran and Turkey have become important trading partners for the Caucasus countries, China is gaining importance for the Central Asian countries and for the European members of the CIS, they are the countries of Central Europe (which have all become members of the EU) and South-East Europe.

* * *

Trade agreements per se, whether bilateral or plurilateral, do not automatically lead to increased trade among the parties. Many other factors, particularly those related to the supply and demand structures of the members' economies, have a considerable influence on intraregional trade performance and its potential impact on their growth and development. A static view of the effects of regional agreements may therefore be misleading. The dynamics of the various regional blocs discussed in this section indicate that the intensity of intraregional trade among developing and transition economies is conditioned by several factors, which may reinforce each other; these include the absorptive capacity of the individual domestic markets for the products of neighbouring countries, which is mainly determined by the relative size of the economies of the region and their per capita incomes and production structures. The potential of RTAs to generate trade among their members, which could help stimulate diversification (resulting possibly in greater complementarities), competition and economies of scale, and promote structural change, is generally circumscribed by weak growth, particularly of the manufacturing sector.

C. Composition of intraregional trade

The benefits of international trade for economic development generally depend on a variety of factors; they cannot be measured simply by the increase in the total value of exports. The degree of the positive impacts of trade expansion on long-term growth will depend on the extent of the linkages between the export sector and the rest of the economy, the amount of employment it creates, the extent of the technological spillovers to the rest of the economy, the proportion of domestic value added in the value of exports, the revenue it generates and the share of that revenue that accrues to domestic actors, which in turn will lay the basis for a strong export-profit-investment nexus (Akyüz and Gore, 1994; see *also TDRs 1996*, chap. II; *2003*, chap. IV; and *2005*, chap. II).

The export sector may have strong linkages with the rest of the economy or it may be a mere enclave, which can be the case when, in a country with limited domestic capabilities, the export sector is based on specific resource endowments such as abundant labour or natural resource deposits. The benefits from hosting TNCs are most positive when inputs are sourced locally and when the host country already has sufficient manufacturing capabilities and human capital to take advantage of potential spillovers (Rodriguez-Clare, 1996). The development effects of FDI for the host country depend on a range of factors, including the amount of technological spillovers from affiliates to domestic enterprises, the creation of backward and forward linkages within the economy, and the impact on domestic investment and employment (UNCTAD, 2007c: 13). In the first-tier Asian newly industrializing economies (NIEs), such spillovers

occurred because the very high rate of capital formation and accompanying industrial policies in these countries meant that domestic firms with absorptive capacity were able to capture some of the “collateral benefits” from hosting FDI. Such effects are more difficult to find in countries where international production networks have been more visible but policy intervention has been weaker. In some cases, high rates of both domestic and foreign investment have helped fuel rapid growth by exploiting a combination of abundant supplies of labour and natural resources. However, reliance on imported inputs or foreign-owned suppliers has meant that the constellation of linkages characteristic of internal integration are weak or missing, limiting the benefits that may otherwise arise from FDI-induced competitiveness.

Internal integration increases the chances of benefiting from FDI, and for the gains from international trade to be dispersed throughout the economy. As long as the export sector is limited to a narrow package of activities, even in the context of international production networks, the likelihood that a dynamic process of upgrading of activities to a more skill-intensive and sustained pattern of industrial growth will occur is rather limited. On the other hand, when TNCs do not integrate into their host economies, they have a much wider choice of sites, which makes them more footloose and thus strengthens their bargaining position with the host government. This can give rise to excessive and unhealthy competition to attract FDI (through fiscal and trade-related concessions), skewing the gains from international and regional trade in favour of TNCs.

In the absence of strong internal integration, TNC-driven industrialization can lead to an enclave-type development pattern, where the production of standardized goods with a high import content threatens to lock countries into low-wage, low-value-added activities characterized by diminishing returns and a growing informal sector. This pattern has been identified in parts of Latin America and the Caribbean, and North Africa. Regional cooperation, including through preferential trade agreements, might still be used to attract FDI. But if this comes at the expense of policy space, it could risk leading to a skewed pattern of development. The use of deliberate macroeconomic, industrial and technological policies are necessary to reduce the probability of the export sector becoming just an enclave. It can also be influenced by the kind of activities in which an economy specializes.

Depending on the specific circumstances and policies in a country, exports of primary commodities can have a strong impact on growth, especially if they generate profits for local agents that are reinvested in a way that contributes to the creation of productive capacity, productivity growth and diversification, in particular in the manufacturing sector. In general, manufacturing activities are more likely than primary activities to create economic linkages with the rest of the economy. The industrialization process should attempt to move into sectors that are more technology- and skill-intensive, with the ability to generate technological spillovers to the rest of the economy. A comparison of the composition of intraregional trade and extraregional trade suggests that the former in many cases offers greater potential for upgrading of exports and manufacturing than the latter.

Figure 4.5 shows the composition of the trade of different regional groupings with their main trading partners by major product category. In Latin America, much of the trade of MERCOSUR, ANCOM and CACM with developed economies follows a traditional pattern: exports consist mainly of primary products and labour-intensive manufactures, while imports consist mainly of medium- and high-technology-intensive manufactures. West-

ern Europe and Japan buy mainly agricultural goods from MERCOSUR and CACM, and mining products from ANCOM. United States imports from Latin America are more diversified: in addition to fuels from ANCOM (mainly the Bolivarian Republic of Venezuela) and agricultural goods from CACM (coffee, fruits), it imports a variety of manufactures from MERCOSUR and labour-intensive manufactures and electronic parts from CACM, originating mainly from the *maquila* assembly industries. Similarly, the trade of these Latin American blocs with developing regions outside Latin America is dominated by manufactured imports and by primary exports, such as agricultural goods from MERCOSUR and oil from ANCOM.

Intraregional exports comprise a much larger share of manufactures, including a high proportion of medium- and high-technology products: 70 per cent in MERCOSUR and more than 60 per cent in ANCOM and CACM. The composition of extraregional exports of CACM and MERCOSUR with other countries in Latin America and the Caribbean is diversified, with a higher share of manufactures than their exports to the rest of the world.

Thus, for most Latin American countries, regional markets are the leading destinations for their manufactured exports, especially for skill- and technology-intensive manufactures.

This is confirmed by examining the exports of different product categories disaggregated by their geographical destination (fig. 4.6). In MERCOSUR, 50 per cent of the exports of high- and medium-skill and technology-intensive manufactures go to Latin American countries, although total exports to Latin America represent only 29 per cent of total MERCOSUR exports. The difference is even greater in the case of ANCOM: 70 per cent of the exports of the more technology-intensive manufactures go to Latin American countries, particularly to other ANCOM partners, compared to 20 per cent of all intraregional exports in total exports. In the case of CACM, more than 40 per cent of the exports of high- and medium-skill and technology-intensive manufactures go to other CACM partners, almost 20 per cent to other Latin American countries, and 35 per cent to the United States and

In many cases intraregional trade offers greater potential for upgrading manufacturing and exports than extraregional trade.

Figure 4.5

COMPOSITION AND DIRECTION OF TRADE, SELECTED REGIONS

(2003–2005 average, in per cent)

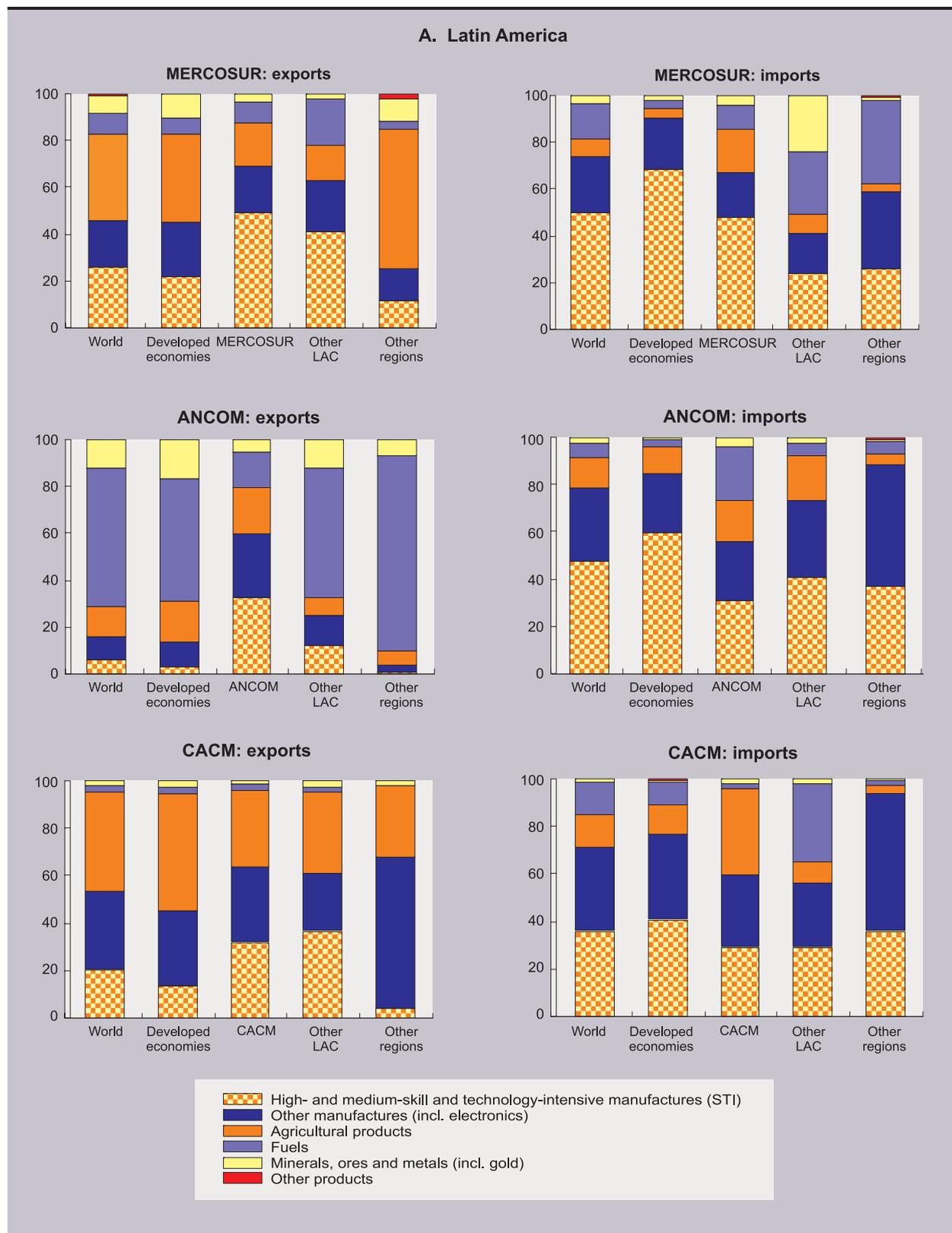


Figure 4.5 (continued)

COMPOSITION AND DIRECTION OF TRADE, SELECTED REGIONS

(2003–2005 average, in per cent)

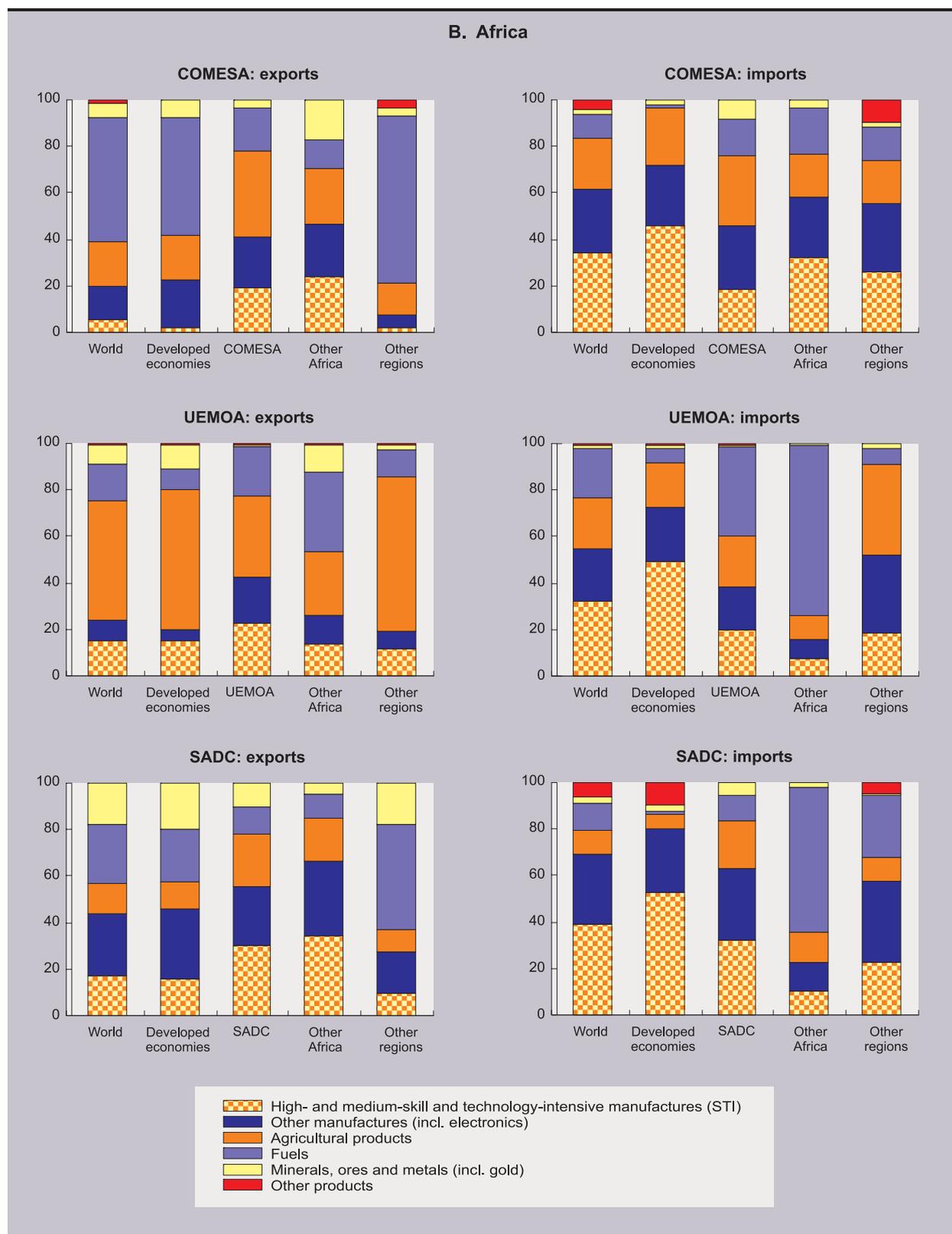
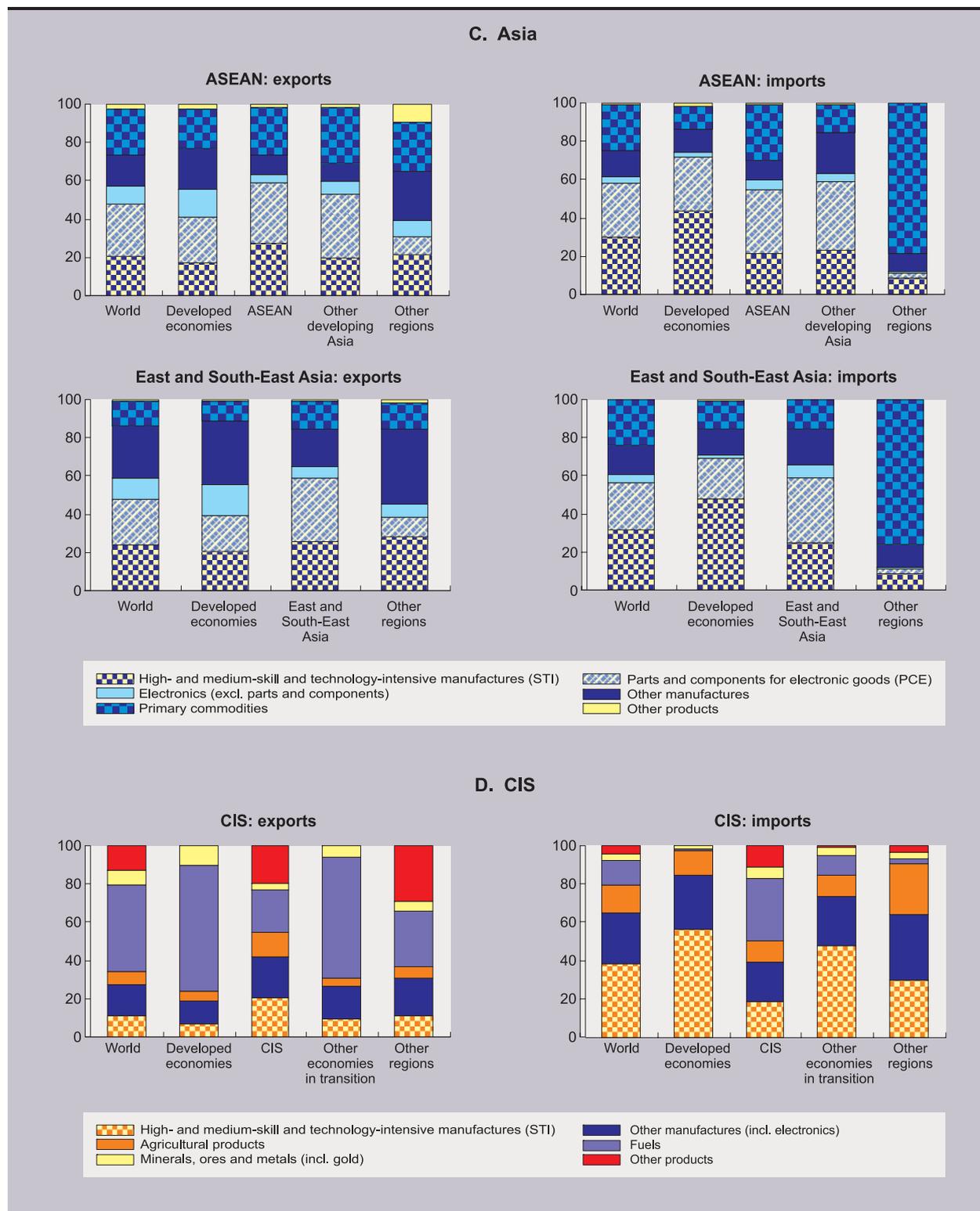


Figure 4.5 (concluded)

COMPOSITION AND DIRECTION OF TRADE, SELECTED REGIONS

(2003–2005 average, in per cent)



Source: UNCTAD secretariat calculations, based on UN/DESA estimates; and UN COMTRADE.

Note: For the composition on product categories, see the notes to this chapter. LAC = Latin America and the Caribbean.

Canada. The importance of regional markets for this product category is corroborated by a country-by-country examination. In Argentina, Colombia, Ecuador and Uruguay, exports to Latin America account for between 32 and 40 per cent of total exports; but the share of exports of the more technology- and skill-intensive manufactures that goes to Latin American countries is close to 80 per cent in all these countries, and reaches 90 per cent in Uruguay. Even in Brazil and Chile, for which the Latin American market is less important – in Brazil owing to its size, and in Chile to its specialization in primary goods – almost 45 per cent of this category (i.e. the higher end of the technology- and skill-intensive manufactured exports) goes to the regional market.

In the African regions, data for the period 2003–2005 indicate that the composition of trade is partly determined by its trading partners (fig. 4.5B). Primary products, mostly fuels, constitute more than three quarters of COMESA exports to developed economies and developing regions other than Africa, while imports from these economies and regions comprise mainly manufactures. Trade with African countries is much more balanced. While manufactured exports from COMESA represent only a small fraction of its total exports, it is nevertheless notable that manufactures account for more than 40 per cent of exports within COMESA and almost 50 per cent of exports to other African countries; half of these are high- and medium-technology-intensive and skill-intensive. As a result, more than 60 per cent of the more sophisticated manufactured exports are sold in Africa (fig. 4.6). The trade structure of UEMOA resembles that of COMESA, but UEMOA's exports of manufactures contain a higher share of medium- and high-technology-intensive products than COMESA's, and the share of manufactures exported to African countries outside the regional group is much smaller than that of COMESA. The share of manufactures in UEMOA's intraregional exports rose from less than 30 per cent in 1995 to over 40 per cent in 2005.

In SADC, and in particular in the subgroup SACU, manufactures comprise a larger share of exports in both intra- and extraregional trade than

in the other African subregions, largely on account of the largest economy in the region, South Africa (fig. 4.5B).¹⁵ The share of manufactures in intraregional exports is particularly high within SADC and with other countries in Africa. Nevertheless, developed economies remain by far the most important market for SADC exports, both primary and manufactured (fig. 4.6). In view of the supply capacity for manufacturing within SADC, this level of intraregional trade seems quite modest. In the case of the SACU subregion, intraregional exports consist mainly of manufactures from South Africa, with few trade flows in the other direction. This is partly due to the relative size of the South African economy, but there also appears to remain considerable scope for South Africa to open its markets to more imports from its SACU partners.¹⁶ Nevertheless, similar to the UEMOA experience, the product composition of intraregional exports in SACU has also shifted towards a greater share of manufactures and technologically more sophisticated products, and such upgrading has also occurred in extraregional exports.

In ASEAN intra- and extraregional trade, more than 75 per cent of both exports and imports are manufactures, particularly electronic goods (fig. 4.5C). In their trade with developed regions, ASEAN countries import mainly high- and medium-skill- and technology-intensive manufactures, and electronic parts and components, while their exports of manufactures are more diversified, including also labour-intensive goods and finished electronic products. There is intense trade of electronic parts and components with East and South-East Asian developing countries, including with ASEAN partners, which reflects the existence of a dense regional production network in electronics industries. On the other hand, given their low endowments of industrial raw materials relative to their level of industrialization and consumption, East and South-East Asian countries, including the members of ASEAN, with a few exceptions, rely to a large extent on imports of primary commodities, especially fuels, from other developing regions. The import structure of ASEAN is very similar to that of the wider geographical

Trade within the same geographical region can often be more conducive to diversification, structural change and industrial upgrading than overall trade.

Figure 4.6

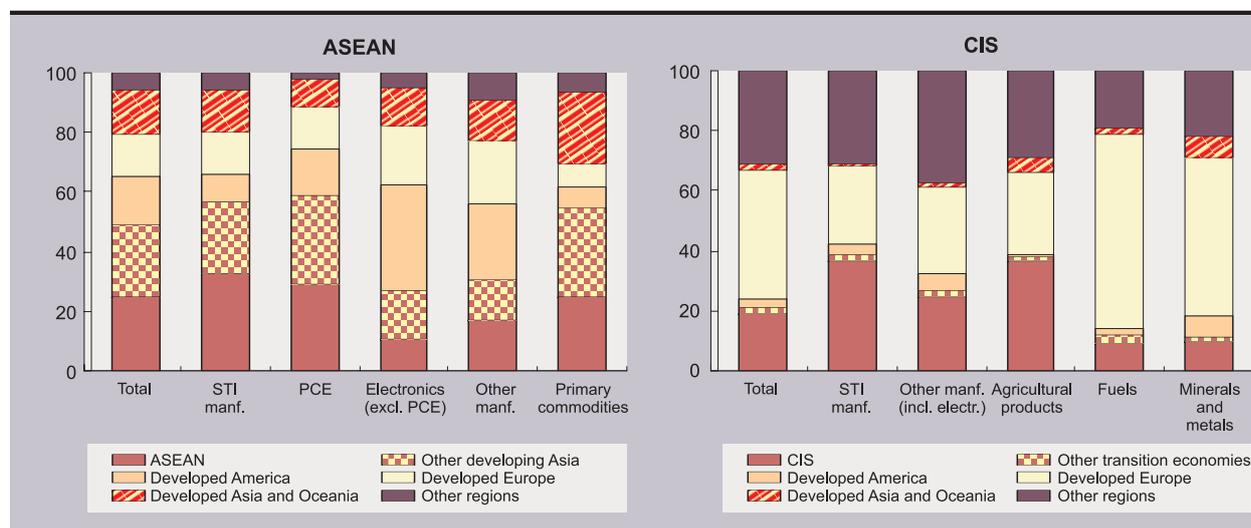
DESTINATION OF EXPORTS BY BROAD PRODUCT CATEGORY, SELECTED REGIONAL BLOCS
(2003–2005 average, in per cent)



Figure 4.6 (concluded)

DESTINATION OF EXPORTS BY BROAD PRODUCT CATEGORY, SELECTED REGIONAL BLOCS

(2003–2005 average, in per cent)



Source: UNCTAD secretariat calculations, based on UN/DESA estimates; and UN COMTRADE.

Note: For the composition on product categories, see the notes to this chapter.

STI = High- and medium-skill and technology-intensive manufactures;

PCE = Parts and components for electrical and electronic goods.

region of East and South-East Asia, the main difference being that the share of parts and components of electronic goods in total imports from and exports to developed countries is considerably higher for ASEAN, indicating that international production networks play a greater role for its members than for other countries in the wider geographical region.

The fact that the international trade of ASEAN countries is closely related to such production networks explains much of its recent dynamism: ASEAN's total and intraregional trade grew at annual average rate of 18 per cent and 21 per cent, respectively, between 2003 and 2005. The trade pattern of the East and South-East Asian region as a whole reflects the way its production structure is organized. It imports high- and medium-technology-intensive goods, including capital goods, mainly from developed countries, electronic parts and components mainly from within the region, and primary commodities mainly from other developing regions. It exports a large proportion of labour-intensive manufactures and final elec-

tronic goods to developed countries, while high- and medium-technology-intensive goods and electronic parts and components are traded largely within the region.

The product composition of exports from the CIS to the rest of the world changed dramatically during the 1990s, with a rapid decline in manufacturing – in both absolute and relative terms – reflecting the decline in the manufacturing industries of the former Soviet Union. Yet in intraregional trade the share of manufactured exports remained relatively stable in the second half of the 1990s and has even increased slightly since 2000. In the natural-resource-rich countries, these earlier losses were compensated to a large extent – and in some cases overcompensated – by increasing export volumes and higher prices of exports of oil, natural gas and other raw materials. Other countries, such as Georgia and the Republic of Moldova, had to rely on agricultural exports. Although commodity prices have shown a rising trend since 2002, this shift to primary commodities has increased the vulnerability of CIS mem-

bers to external shocks, and may weaken their potential for long-term growth, especially as it is largely the result of a decline in manufacturing. Most governments in these economies recognize this problem, but a large proportion of the domestic and foreign investment in them still goes to the extractive industries where high returns can be expected in the short run (ECE, 2005: 62). Another problem regarding the specialization of several CIS members in extractive industries is that this sector is capital-intensive and requires relatively little labour, which means that it cannot directly contribute to substantial job creation.

Summing up, regional blocs of developing countries and economies in transition constitute important and, in many cases, dynamic markets for the manufactured exports of their members, even if the size of these markets is relatively small. Evidence suggests that owing to its product com-

position, trade within the same geographical region can often be more conducive to diversification, structural change and industrial upgrading than overall trade. Geographical proximity matters as much as the initial domestic structure of economic activity in each country, but RTAs, as well as other arrangements at the regional level that foster trade integration and greater product diversity, especially in the manufacturing sector, can enhance the positive impact of intraregional trade. Obviously, the geographical directions of external integration – intraregional, with other developing regions or with developed countries – are not mutually exclusive: a country may benefit from expanding its exports to all these markets. However, for a developing country seeking to move up the production ladder and, in particular, to accelerate and upgrade domestic technology and manufacturing, stronger regional integration can provide an important impetus.

D. The potential role of South-South regional trade agreements

Regional economic integration arrangements among developing countries have been considered key to promoting industrialization, as exemplified in the arguments put forward for the creation of a Latin American common market in the late 1950s. In Latin America, where several countries had reached a significant degree of industrial development, regional integration was seen as providing the necessary elements for industrial upgrading, since new, more complex industrial structures necessitated economies of scale through the provision of a larger market. As stated by ECLAC (1959: 329) production should not remain “in twenty separate compartments”. Moreover there was a growing awareness that without such indus-

trial upgrading, the gap vis-à-vis the more advanced industrial countries would keep widening.

The expansion of intraregional trade and, in particular, the importance of regional markets for manufactures, discussed in the previous sections, confirm that regionalism can help the process of industrialization and efficiency gains through intra-industry trade. However, the distribution of the gains among the members of a regional bloc and the economic agents may be quite unevenly spread. A priori, one would expect the smaller countries (and the smaller firms) to benefit the most from a wider market. But the free play of market forces may accentuate inequalities when initial condi-

tions are unequal. In the absence of policies aimed at reducing asymmetries, the more developed countries – and geographical regions within countries – tend to benefit more from the larger regional space than the less advanced countries or regions. Similarly, TNCs may benefit from the wider economic space by being able to organize their production and distribution networks at the regional level much more easily than small- and medium-sized firms.

One indicator of the distribution of gains within a regional bloc is the intraregional structure of trade surpluses and deficits (table 4.2). It appears that, in general, countries at higher levels of industrial development and diversification, such as South Africa in SADC, Côte d'Ivoire in UEMOA, Kenya in COMESA, India in SAARC, Brazil in MERCOSUR, Colombia in ANCOM and the Russian Federation in the CIS, achieved surpluses in their trade with their regional partners, while the less advanced (and frequently smaller) members of the blocs recorded intraregional trade deficits. This asymmetry is exacerbated by the fact that the trade surpluses in the larger, more developed members usually account for a small proportion of their GDP, while the deficits in the smaller, less developed members often represent a significant proportion of their GDP.

These asymmetries are due largely to structural factors, but in many cases also to economic policies. In a customs union or a common market, the structure of the common external tariff and the local content requirements may suit some members more than others. Moreover, the members of a regional agreement frequently follow their own industrial policies, either in accord with their partners or unilaterally. These policies may be “defensive”, if aimed at protecting some economic activities or firms, or “offensive”, if their objective is to encourage exports and investment in specific sectors. In any case, there is a risk that the lack of coordination of industrial policies could lead to “beggar-thy-neighbour” behaviour, rendering economic convergence among the regional partners more difficult and eventually weakening

the integration process. Differing financial and institutional capacities among the members of a regional bloc for encouraging production and exports could also accentuate existing asymmetries within the bloc. The EU dealt with this problem by harmonizing the different public support policies of its members, and by adding a Community dimension to structural policies. Its structural and cohesion funds help to support regional development projects in the less advanced – mostly outlying – regions within the EU and also imply a net financial transfer from members with higher per capita incomes to those with lower incomes.

In regional cooperation initiatives among developing countries, addressing disequilibria and inequalities has received relatively little attention so far, but there are examples from Africa and

Latin America of an awareness of the need to find a regional approach to these issues. SACU contains provisions to encourage the development of the less advanced members and the diversification of their economies. Since 1969, South Africa has made net financial transfers to the governments of the other four SACU member States through a common revenue fund, which pools all the tariff

revenues of the five countries. Distinct from the practice in other customs unions, the distribution of customs duties among member countries is based on their respective shares in both extra-regional and intraregional imports. South Africa has a much higher propensity for extraregional imports than the other SACU members, and a lower propensity for intraregional imports. Thus the smaller SACU members derive a greater proportion of benefits than their participation in the revenue pool. The rationale for this redistribution is to compensate the smaller economies for the asymmetries and price effects that could result from their membership in the customs union, and for the loss of some fiscal and policy autonomy (Hansohm and Adongo, 2006; Flatters and Stern, 2005; and Kalenga, 2005). The SACU agreement also contains provisions for the use of instruments in support of industrialization and diversification, taking into account the specific circumstances of the smaller and less advanced member States and

Regionalism can help the process of industrialization and efficiency gains through intra-industry trade. However, the benefits may be unevenly distributed.

Table 4.2

INTRAREGIONAL TRADE BALANCE IN SELECTED REGIONAL BLOCS, 2000–2006

(Millions of dollars and per cent, annual average)

Surplus countries			Deficit countries		
	Value of trade balance (\$ million)	Trade balance in per cent of GDP		Value of trade balance (\$ million)	Trade balance in per cent of GDP
UEMOA					
Côte d'Ivoire	619	4.4	Mali	-372	-8.9
Senegal	171	2.6	Burkina Faso	-246	-6.1
Togo	60	3.4	Niger	-82	-3.3
			Others	-117	-3.1
SADC					
South Africa	3 022	1.7	Zambia	-557	-10.1
			Mozambique	-533	-10.3
			Zimbabwe	-474	-11.2
			Others	-1 600	-3.3
COMESA					
Kenya	708	4.4	Uganda	-346	-4.8
Zimbabwe	57	1.3	Sudan	-146	-0.8
Mauritius	52	1.0	Dem. Rep. of the Congo	-146	-2.3
Egypt	34	0.0	Others	-365	-0.8
CACM					
Costa Rica	432	2.4	Honduras	-408	-5.6
Guatemala	355	1.4	Nicaragua	-264	-6.0
			El Salvador	-102	-0.7
MERCOSUR					
Brazil	1 308	0.2	Paraguay	-643	-9.4
			Uruguay	-597	-3.8
			Argentina	-225	-0.1
ANCOM					
Colombia	1 237	1.3	Peru	-806	-1.2
Bolivia	174	2.0	Ecuador	-728	-2.6
			Venezuela (Bolivarian Republic of)	-331	-0.3
SAARC					
India	2 845	0.4	Bangladesh	-1 518	-2.7
			Sri Lanka	-933	-4.7
			Others	-401	-0.4
CIS					
Russian Federation	7 213	1.4	Ukraine	-5 857	-10.0
Turkmenistan	1 131	21.8	Belarus	-3 139	-15.2
Uzbekistan	38	0.3	Kazakhstan	-2 300	-5.9
			Others	-2 133	-9.1

Source: UNCTAD secretariat calculations, based on IMF, *Direction of Trade Statistics* database; national sources; and UNCTAD *Handbook of Statistics* database.

Box 4.1**THE MERCOSUR STRUCTURAL CONVERGENCE FUND (FOCEM)**

The MERCOSUR Structural Convergence Fund (FOCEM) addresses the problem of economic asymmetries within the common market. It is an instrument for transferring funds from Argentina and Brazil to Paraguay and Uruguay. The members of MERCOSUR contribute to the Fund in the following proportions: Brazil 70 per cent, Argentina 27 per cent, Uruguay 2 per cent and Paraguay 1 per cent. Total annual committed contributions amount to \$100 million between 2006 and 2015. The Fund co-finances the individual projects submitted by each member State, but the distribution of the total resources among the four countries is predetermined: Paraguay will receive 48 per cent of total grants, Uruguay 32 per cent, and Argentina and Brazil 10 per cent each. The first 11 projects that had been presented to FOCEM by January 2007 include projects in housing (Paraguay), road construction (Uruguay and Paraguay), and support for micro-firms (Paraguay). FOCEM also plans to finance a laboratory for biological security and food control (Paraguay), the development of software, biotechnology and electronics industries (Uruguay) and a programme to prevent foot-and-mouth disease (in the four MERCOSUR members plus Bolivia).

their needs in terms of financial support and policy space for industrial support measures. For example, it allows the smaller SACU members to protect their nascent industries by imposing restrictions on certain imports, whether from South Africa or non-SACU countries.¹⁷ In 2002, public sector revenues from SACU import tariffs amounted to 4.5 per cent of GDP in Botswana, 7.8 per cent in Namibia, 12.9 per cent in Swaziland and 19.8 per cent in Lesotho, compared to only 1.2 per cent in South Africa (Flatters and Stern, 2005; Iyambo et al., 2002). The 2002 revision of the initial SACU agreement dating back to 1969 has rendered the revenue-sharing formula less favourable for the smaller member States, but it continues to have a strong redistributive effect that is fairly significant for them.

The question of economic asymmetries has also received greater attention in the two South American regional blocs, ANCOM and MERCOSUR. Although the role of the State in shaping regional integration was reduced in the 1990s, this did not preclude the continuation of national promotion policies, which tended to put producers in the smaller or less advanced countries with less powerful promotion instruments at a disadvantage. Due to the lack of coordination in this area, trade

liberalization repeatedly led to conflicts and to defensive – and sometimes unilateral – measures. This was aggravated by macroeconomic shocks, in particular abrupt shifts in real exchange rates, which prompted the temporary reintroduction of internal tariffs and other barriers to trade. Thus a process of effective integration will benefit as much from regional measures to prevent monetary instability, which hinders the creation of economic linkages in the wider economic space, as from measures that prevent contradicting support policies by the member States (Porta, 2007).

In recent years, there have been some efforts at addressing the problem of asymmetries. For example, in 2004 ANCOM launched the Andean System of Credit Guarantee for small and medium-sized enterprises and a system for promoting intra-regional exports; and in July 2005 MERCOSUR established a Structural Convergence Fund that supports investments in the member States aimed at helping to improve the distribution of costs and benefits in the enlarged market (box 4.1).¹⁸

* * *

In sum, the growing volume of intraregional trade, and in particular, the greater importance of

regional compared to global markets as outlets for manufactures produced in developing regions supports the strategy of linking industrialization and regionalism. In practically all regional blocs involving developing and transition economies, regionally produced manufactures, including the more skill- and technology-intensive product categories, find markets more easily in countries in the same region than in international markets further away. There is therefore considerable

scope for developing and transition economies to benefit from advantages of geographical and cultural proximity when seeking to develop their industries and upgrade their production. Regional industrial cooperation does not preclude integration into the wider global economy, but it may serve as a vehicle to achieve global competitiveness. For it to be successful, members of the regional bloc need to cooperate in certain policy areas that may include agreeing to the full liberalization of intraregional trade, and, in customs unions, establishing a common external tariff. However a regional dynamic will rarely be triggered by trade liberalization alone. Like the catch-up process in a single country, a common effort to reduce the gap with more advanced economies, is more likely to succeed when measures related to trade and finance are complemented by other measures, as discussed elsewhere in this *Report*. For regional integration to be viable in the long run, some common regional policies and institutions may need to be developed to prevent greater income divergence among and within member States as a result of integration, which might trigger defensive measures on the part of the disadvantaged members and weaken the integration process.

An approach to regional cooperation, whether it is among developing countries or between de-

veloped and developing countries, that focuses on trade liberalization alone may be consistent with the view of regional agreements as building blocs

for a system of global free trade and capital flows. However, if regional integration is understood as an element of a broader development strategy aimed at faster domestic capital accumulation and technological progress in the most promising industrial and service sectors according to the local circumstances, this approach

is unlikely to achieve the desired results. It would imply that governments have to give up policy options that were decisive for industrial development in almost all of today's developed and the more advanced developing countries, without gaining additional policy space through regional cooperation.

An alternative approach would consider regional integration among developing countries as providing a space for a development strategy based on industrialization. This has greater chances to succeed than isolated national strategies, especially for countries with small domestic markets. It will require giving up some sovereignty in national policy-making, but at the same time mem-

bers may find their policy space enlarged through cooperation at the regional level. A regional economic space must provide a durable framework for long-term decisions, in order for an enlarged market to provide incentives for investment and structural change. Allowing the relatively free movement of goods would not be enough to assure the sustainability of that

framework. Proactive regional economic policies should also be developed that aim at fostering structural change, taking advantage of potential complementarities and specialization among the member countries and increasing the productive capacities of the less developed members. ■

An approach to regional cooperation that focuses on trade liberalization alone is unlikely to achieve the desired results.

Regional integration should be an element of a broader development strategy aimed at faster domestic capital accumulation and technological progress.

Notes

- 1 For member countries of the different regional blocs discussed in this *TDR*, see list at the beginning of the *Report* (page *xvi*).
- 2 In the Southern Common Market (MERCOSUR), the automobile industry is protected with the highest tariff rate (35 per cent) of the common tariff structure.
- 3 Ministry of Commerce of China website, at: www.mofcom.gov.cn (accessed on 2 April 2007).
- 4 China-ASEAN Trade Cooperation Has Entered a New Development Phase in 2005, Press Office of MOFCOM, 2005; available at: www.mofcom.gov.cn/ai/8/dyncolumn.html.
- 5 Unless otherwise specified, all the data used in this section that is related to the trade of countries and groups of countries are based on the IMF *Direction of Trade Statistics* database.
- 6 Since the Bolivarian Republic of Venezuela left ANCOM and started the process for joining MERCOSUR only in 2006, it has not been included as part of MERCOSUR for the purpose of this analysis.
- 7 CAFTA consists of a series of bilateral FTAs between the United States, on one side, and individual Central American countries on the other. By spring 2007, the Costa Rican Parliament had not yet ratified the treaty, and a referendum on it was announced.
- 8 This has long been understood to occur with FDI in the primary sector, where imported capital, skilled labour and inputs, have tended to generate large export earnings but weak local linkages, and countries strongly reliant on their primary sector have been particularly vulnerable to unfavourable movements in their terms of trade. For an analysis of the linkages generated by FDI in extractive industries, see UNCTAD, 2007b.
- 9 In 2005/2006 SAARC members accounted for 57 per cent of Nepal's exports and for 48 per cent of its imports. The respective figures for Sri Lanka are 10 and 21 per cent, for the Maldives 15 and 17 per cent, and for Bangladesh 2 and 14 per cent.
- 10 Exports from most SACU members are overwhelmingly directed to the rest of the world, in particular the EU and the United States. With regard to imports, however, Botswana, Lesotho, Namibia and Swaziland are highly dependent on South Africa, which accounts for 70 per cent or more of each of these countries' total imports (Metzger, 2006: 52).
- 11 These strong trade links appear to be due mainly to bilateral trade agreements between these countries and South Africa rather than to trade liberalization within SADC (Visser and Hartzenberg, 2004: 8–10).
- 12 An in-depth analysis of the process of disintegration of the CIS and the former COMECON during the 1990s is provided in ECE, 2003.
- 13 Data after 1994 are from the IMF, *Direction of Trade Statistics* database. For longer term assessments of trade relations in the former Soviet Union and the CIS, see Belkindas and Ivanova, 1995.
- 14 Differences in reported imports and exports between pairs of countries within the CIS are often larger than what is reflected in transport costs, indicating a general problem of data reliability. Problems with data and reporting with regard to CIS trade are discussed in Freinkman, Polyakov and Revenco, 2004: 1–5.
- 15 In SACU (that is not included in figures 4.5 and 4.6), manufactures accounted for around 60 per cent of exports to developed-country markets, and for two thirds of all SACU exports to African countries in 2002–2005. While the largest share of these manufactured exports is from South Africa, it is worth noting that smaller SACU partners also have a significant share of manufactures in their total exports.
- 16 Several observers have drawn attention to the protection of the South African market by restrictive local content requirements within SACU, on the one hand, and South Africa granting of unilateral tariff rebates on a number of extraregional imports, on the other (Gaomab and Hartmann, 2006: 54–55; Kalenga, 2005: 19–20; WTO, 2003: x).
- 17 All SACU members are WTO members. In a 2003 report on SACU, the WTO secretariat expressed some concerns relating to the imposition of duties using a formula based on reference prices. It was

believed that this may undermine SACU countries' compliance with their tariff bindings and with their obligations under the Customs Valuation Agreement. Concerns were also expressed about differences in tariff bindings among SACU countries, and about the extensive use of anti-dumping and other contingency trade remedies by South Africa on behalf of the customs union (WTO, 2003: ix).

- 18 With a view to reconciling national industrial policies, since 2006 Argentina and Brazil have agreed to a mechanism of competitive adaptation, under which the introduction of protective tariffs in bilateral trade are allowed for a maximum period of four years in case of a sudden surge of imports in one country that threatens a productive sector. During this period the government and the private sector in the protected country must restructure that sector.

Notes for figures 3.5, 4.5 and 4.6:

The product categories are based on the Standard International Trade Classification (SITC), Rev. 3: High-skill and technology-intensive manufactures (SITC_5+792+87+88+891-525); Medium-skill and technology-intensive manufactures (SITC_62+893+71+72+73+74+771+773+774+778+781+782+783+784); Low-skill and technology-intensive manufactures (SITC_67+69+78-781-782-783-784+79-792); Labour- and resource-intensive manufactures (SITC_61+63+64+65+66+82+83+84+85); Electronics (excluding parts and components) (SITC_751+752+761+762+763+775); Parts and components for electrical and electronic goods (SITC_759+764+772+776); Manufactured goods (SITC_5+6+7+8-68); Agricultural products (SITC_0+1+2-27-28+4); Fuels (SITC_3); Minerals, ores and metals (SITC_27+28+68+97); Primary commodities (SITC_0+1+2+3+4+68+97).

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REGIONAL FINANCIAL AND MONETARY COOPERATION

A. Introduction

Financial and monetary cooperation has been a longstanding and repeatedly recurring issue in international economic integration. Long before modern pressures from a globalized market emerged, exchange of trade and services between countries with different monetary units has been accompanied by attempts to simplify the final settling of bills and to smooth the financial implications of real resource transfers. The leading idea behind international financial cooperation has been the conviction of early global traders that only a monetary system comparable in its efficiency to the monetary systems prevailing in the nation state would allow to exploit fully the benefits of a global division of labour. However, after the failure of early global monetary systems like the Gold Standard and the end of the most recent global monetary system, Bretton Woods, disintegration in monetary affairs has ruled the day.

With the opening of the capital accounts of developing countries on a broad scale in the 1990s the monetary challenge was back on the agenda of international cooperation in general. Obviously, the pressure to create new multilateral rules to

regulate volatile speculative financial flows grew dramatically with the dismal experiences of a number of countries in big financial crises in Asia, Latin America and the transition economies. The big powers, however, the countries who are big and self-contained enough to withstand even strong blows from the globalized capital market, were reluctant to engage in a truly global exercise to monitor and eventually control the global financial markets in the same way as national financial markets have been controlled since the beginning of market systems based on government issued paper money.

As a consequence, the choices for small and open developing economies to deal with huge and uncontrolled capital flows are strictly limited. As the means to steer and restrict such flows by administrative measures are constrained by trade openness and many other ties that cannot be fully cut, one option is to “tie its own hands” by attaching firmly the own national monetary system to the monetary system of one of the big powers and to adjust the real system accordingly. Dollarization, eurozation and other forms of fixing its own cur-

rency firmly to an anchor currency or allowing a foreign currency to penetrate national markets as “parallel currency” demonstrate better than anything else the helplessness of small countries in their struggle with the global capital markets.

A second option for small open economies is to join forces in regional groupings. If the regional trade ties are strong and the mobility of capital and labour is rather high regional financial and monetary cooperation and integration is a way to protect against the gyrations of international capital markets and to deepen and broaden the division of labour at the regional level. Renewed interest for regional monetary and financial cooperation is also related to the difficulties most developing countries face in their access to foreign financing under favourable conditions in terms of maturity, interest rates and currency denomination.

Regional monetary and financial cooperation also appears as a necessary complement to deepening regional trade integration. Cooperation in trade and finance have typically reinforced each other. For instance, regional payment and clearing agreements among trading partners help in developing intraregional trade, especially in times of foreign currency shortage; and trade integration makes it necessary to address exchange-rate misalignments or volatility, which can be as, if not more, harmful for trade within a region than tariff barriers. In the absence of global arrangements for bringing about greater exchange-rate stability and orderly correction of currency misalignments, monetary arrangements among developing countries, especially in advanced integration arrangements, hold the potential for achieving this, while at the same time promoting overall competitiveness; such monetary coordination may take the form of a regional exchange-rate mechanism, common-bloc floating or a monetary union.

At present, several emerging countries are responding to these problems through active interventions in the exchange markets and the accumulation of international reserves. These poli-

cies tend to avoid – or limit – exchange-rate misalignments and to provide a self-insurance to the vagaries of the international financial markets. However, a cooperative approach together with regional partners might provide better results than separate national actions. Several initiatives are actually under way, which address the problems not satisfactorily managed at the international level: swap agreements and pooling of reserves among Central Banks; exchange-rate coordination mechanisms; regional supervisory institutions; a more intensive use of regional payment agreements, which could include the use of domestic currencies in regional trade; and the expansion – or creation – of regional development banks and regional bond markets, as a way to boost the access to long-term financing. In fact, it seems that monetary and financial cooperation has gained a more prominent role in regional integration processes (Higgott, 2002).

This chapter examines three major areas in which regional monetary and financial cooperation may help in dealing with international financial system shortcomings. Section B will present part of the rich experience already accumulated

by developing countries in regional payment facilities and short-term financing. Even though these mechanisms were primarily related to trade facilitation, they may evolve towards more ambitious regional financial arrangements that may provide a complement – or, in some circumstances, a substitute – to multilateral sources of balance of payment financing. Section C presents the role of regional cooperation in the provision of development financing; in particular, it stresses the function of regional and subregional development banks. It also examines the initiative for creating regional bond markets, which could become a stable source of financing for companies, banks and public entities in the region, while at the same time offering regional investors, including pension funds, options for wealth accumulation. Section D describes the most advanced experiences in regional exchange-rate mechanisms (ERM) and monetary unions, aimed at preserving a regional market from exchange-rate volatility, which have taken place

A cooperative approach with regional partners on monetary and financial matters might provide better results than separate national actions and help in dealing with shortcomings in the international financial system.

in Europe and Africa. Section E explains the main lessons to be learned from the European experience for monetary cooperation and monetary

policy in developing countries. Finally, section F draws some conclusions for the global and regional monetary institutions.

B. Regional cooperation for payment facilities and short-term financing

Payment and credit agreements among central banks are aimed at facilitating intraregional trade as well as providing liquidity financing to the member countries of a trade agreement. A clearing arrangement among a group of central banks is an instrument directly related to trade integration. It provides a mechanism to facilitate international transactions between countries, typically concerning trade in goods but sometimes extended to services (such as tourism) and financial flows. Through this facility, the participating central banks compensate the cross payments owed to each other for balance-of-payments transactions carried out during a given period and then settle the remaining debt in hard currency on a pre-established date. Thus countries participating in such payment arrangements need less international liquidity for carrying out their intraregional trade, benefiting from short-term credit until the date of settlement.

An early and successful payments agreement was launched in Europe in the aftermaths of the Second World War. A European Payments Union (EPU) was created in July 1950 as a multilateral clearing system for trans-national payments among the members of the Organisation for European

Payment and credit agreements among central banks are aimed at facilitating intraregional trade as well as providing liquidity financing to the member countries of a trade agreement.

Economic Cooperation (OECE).¹ At the end of each month, net balances among EPU countries were reported to the Bank for International Settlements, the EPU's financial agent, which cleared offsetting claims. Remaining balances were consolidated as assets or liabilities towards the EPU as a whole. As a result, the effective use of gold and dollars was only 25 per cent of what would have been required without this mechanism. At a moment of foreign currency scarcity the EPU permitted a strong expansion of intra-European trade, from \$10 billion in 1950 to \$23 billion in 1959 (Eichengreen and Braga de Macedo, 2001: 2–3). The EPU also provided for credit facilities extended to countries in balance-of-payments difficulties. It existed until 1958, when all member states introduced general foreign currency convertibility for current transactions within the Bretton Woods System.

Among the developing regions, Latin America has a long and overall successful experience in this field (Pasin, 2007). In the 1960s, Central American countries created a clearing house to act as a delayed net payment system; and in 1969, they founded the Central American Monetary Stabilization Fund (MSF) in order to finance balance-

of-payments imbalances. This was conceived as “a complement of the International Monetary Fund”. However, the operations of the MSF were suspended in the mid 1980s following the widespread payment difficulties of participating central banks.

The Latin American Free Trade Association (later transformed into the Latin American Integration Association, LAIA) established in 1965 a reciprocal credit and payment agreement among the central banks (RCPA). It functioned as a clearing house and a short-term credit mechanism for trade transactions. Subsequently, a credit facility for central banks facing liquidity problems (the Santo Domingo Agreements) was added to that mechanism.²

Within the RCPA, international payments resulting from trade transactions were cleared to facilitate payments among member countries. It also made these payments less expensive, since it eliminated triangulation with banking institutions outside the region. Additionally, the RCPA provided a short-term credit facility to cover central bank deficits, which were charged an interest rate of LIBOR plus 100 basis points. Moreover, as each central bank assumed responsibility for paying the creditor central bank even if the issuing commercial bank had failed to fulfil its obligations, exporters using the mechanism were covered from commercial risk. In the late 1980s, about 90 per cent of intraregional trade transactions were channelled through this mechanism. The payment agreement helped save up to 75 per cent of the hard currency that would otherwise have been needed. With abundant liquidity and capital liberalization during the 1990s, the mechanism lost its importance for trade financing. However, it is still in place and could be used more intensively as a clearing system for operations in national currencies.³

In 1978 the Andean countries (which are also members of LAIA) reinforced their own trade integration agreement with the establishment of a reserve fund (the Andean Reserve Fund, later transformed into the Latin American Reserve Fund, FLAR), where central banks pooled part of their reserves. Initially it only included countries from the Andean Group but during the crisis of the 1980s it was opened to other Latin American countries (so far, only Costa Rica has joined the

FLAR). Member countries have access to medium-term credits (3 years term) for balance-of-payment and debt rescheduling financing. They also have access to a liquidity facility of up to a one-year term, to contingency facilities (six months) and to treasury finance (from one to thirty days). The FLAR offers services such as the administration of reserves, repurchase operations and values custody, as well as accepting sight and fixed-term deposits. It also issued notes in the international capital markets in 2003 (\$150 million) and 2006 (\$250 million) at rather low spreads (FLAR has been given an A+ rating by Standard and Poor's). In 2006 it issued a 5-year term floating note indexed at LIBOR plus 20 basis points.

Similarly the Arab Monetary Fund (AMF), created in 1976 by 22 West Asian and African states, provides financing for balance-of-payments imbalances with conditions tailored to each beneficiary's situation, conditions that are much less strict than those of the IMF (Corm, 2006: 309). The Fund intends to be “a lender of last resort and a complementary rather than a principal source for financing those (balance-of-payments) deficits” (AMF, 2003: 13). Member countries can resort to different lending facilities: “automatic loans” and “ordinary loans” to finance balance-of-payment deficits; “extended loans” when the balance-of-payments problem is of a structural nature and requires a longer repayment term (up to seven years); “compensatory loans” to face unexpected shortfalls in exports receipts; and since 1997, the AMF offers a “structural adjustment facility”, which has been used especially for supporting reforms in the financial and banking systems as well as in the government finance sector. The maximum amount of financial support a member country may access is 475 per cent of its subscription to the Fund's capital in convertible currencies (AMF, 2003: 4–11; AMF, 2006: 7–9). The AMF's objectives also include developing Arab financial markets, establishing modes of monetary cooperation and paving the way towards a unified Arab currency. The outstanding loans of the Fund at the end of 2005 amounted to the equivalent of \$1.1 billion.

In Africa, the Common Market for Eastern and Southern Africa (COMESA) established a clearing house in 1984 that aimed at reducing the need for hard currency in intraregional trade; it

also housed a reinsurance company (allowing smaller insurance companies to spread their risks through a wider COMESA pool) and a regional bank: the COMESA Trade and Development Bank.

Some of these mechanisms of mutual credit, as mentioned above, had to be abandoned during the debt crisis of the 1980s since their financing capacities were insufficient to cover the huge financing needs that arose simultaneously for a large number of countries. When the situation in the international financial markets changed towards the end of the decade and most economies regained access to private credit, doubts about the usefulness of regional financial mechanisms increased. Indeed, during much of the 1990s the abundance of international financing reduced the need for mutual assistance among central banks or for regional payment mechanisms that had been designed for saving foreign currencies in an environment of scarce private capital inflows and widespread capital controls. Moreover, the expansion of international banks, which installed new branches in many emerging economies, created a network of private financial flows and payments that replaced the existing agreements among central banks to a large extent.

The idea of creating a regional mechanism for mutual support to cope with possible balance-of-payments problems regained strength after the late 1990s financial crises. In Asia, the 1997–1998 financial crises proved to be a watershed with regard to monetary cooperation in the region, as existing regional and multilateral institutions failed to handle the crisis with an immediate and adequate reaction to the economic turmoil. Therefore, ASEAN member countries initiated a process of cooperation on monetary and financial issues with their major partners in East Asia, China, Japan, and the Republic of Korea. This culminated in the formalization of the ASEAN+3 group in 1999. In May 2000, ASEAN+3 countries launched the Chiang Mai Initiative (CMI), which constitutes the most prominent bilateral swap arrangement to include developing countries (Park et al., 2006: 271).

The proposal for creating a regional mechanism for mutual support to cope with possible balance-of-payments problems aroused increasing interest following the financial crises of the late 1990s.

The CMI is geared both to crisis management and crisis prevention by providing participating countries with international financial liquidity through its two major pillars: the expanded ASEAN Swap Arrangement and the bilateral Swap network. The original ASEAN Swap Arrangement had already been introduced by the five founding ASEAN members back in 1977 and was intended to dampen temporary liquidity shortages (Wang and Andersen, 2002: 90). In May 2000, the ASEAN Swap Arrangement was expanded to all member countries and the available fund was increased from the initial amount of the equivalent of \$200 million to \$1 billion (Park, 2006: 245). Five years later, in April 2005, the ASEAN Swap Arrangement was raised once again from \$1 billion to \$2 billion. In case of liquidity problems, central banks of member countries are entitled to swap their own currencies against key international currencies, e.g. dollar, euro and yen, for a period of up to six months (with one possible prolongation of another six months) and to an amount of a maximum of twice their commitment under the expanded ASEAN Swap Arrangement (Rajan, 2006: 5; Wang and Andersen, 2002: 90).⁴ For the respective currencies, LIBOR determines the interest required for swap transactions. Any request for financial support has to be put to the Agent Bank, which is appointed on rotation and responsible for coordination of financial support.

The second pillar of the CMI consists of a network of bilateral swap arrangements among eight ASEAN+3 member countries (table 5.1). As of mid 2006, six one-way and ten two-way bilateral swap arrangements had been concluded, with a total amount of the equivalent of \$75 billion, of which \$65 billion are provided by China, Japan and the Republic of Korea alone. Of the total amount agreed upon in the swap arrangements, 60 per cent are in local currency. However, participating countries have immediate access only up to a maximum of 20 per cent of the facility and only by consent of the swap-providing countries (Park, 2006: 251; Rajan, 2006: 5). For any further drawings above that threshold, IMF approval is

Table 5.1

BILATERAL SWAP ARRANGEMENTS UNDER THE CHIANG MAI INITIATIVE

(Billions of dollars)

From: \ To:	China	Japan	Rep. of Korea	Indonesia	Malaysia	Philippines	Singapore	Thailand	Total
China	..	3.0 ^a	4.0 ^b	2.0	1.5 ^c	1.0 ^d		2.0 ^c	13.5
Japan	3.0 ^a	..	13.0 ^e	6.0	1.0 ^f	6.0	3.0	3.0	35.0
Rep. of Korea	4.0 ^b	8.0 ^e	..	1.0	1.5	1.5		1.0	17.0
Indonesia			1.0	..					1.0
Malaysia			1.5		..				1.5
Philippines		0.5	1.5			..			2.0
Singapore		1.0					..		1.0
Thailand		3.0	1.0					..	4.0
Total	7.0	15.5	22.0	9.0	4.0	8.5	3.0	6.0	75.0^c

Source: UNCTAD secretariat calculations, based on Ministry of Finance, Japan (2006).

a Local currency swap between the Japanese yen and the Chinese yuan.

b Local currency swap between the Chinese yuan and the Korean won.

c The total of \$75.0 billion includes the bilateral swap arrangements (BSAs) between (i) China and Thailand and (ii) China and Malaysia, which are currently under negotiation for renewal, but does not include the BSA under the New Miyazawa Initiative and the ASEAN Swap Arrangement.

d Local currency swap between the Chinese yuan and the Philippine peso.

e Local currency swap between the Japanese yen and the Korean won.

f In addition to the BSAs under the Chiang Mai Initiative, there are other BSA under the New Miyazawa Initiative between Japan and Malaysia (\$2.5 billion) and the multilateral ASEAN Swap Arrangement (\$2 billion).

required. The maturity of the first drawing is 90 days and can be renewed seven times at maximum; member countries have to pay interest on the use of the swap facility in the range of LIBOR plus 150 basis points for both the first drawing and the first renewal, up to LIBOR plus 300 basis points for the last two renewals (Wang and Andersen, 2002: 91). At present, the CMI is evolving into a multilateral agreement in which part of the participants' reserves would be pooled. In their Kyoto Meeting of May 2007, the finance ministers of the 13 countries agreed to advance progressively towards "a self-managed reserve pooling arrangement governed by a single contractual agreement" for providing liquidity support. This "multilateralisation" of the CMI will also include a regional surveillance mechanism (Joint Ministerial Statement of the 10th ASEAN+3 Finance Ministers' Meeting, 5 May 2007⁵).

Several proposals for strengthened financial and monetary cooperation are also being discussed in Latin America. Some of them would replicate

the CMI arrangement of bilateral swap agreements, while others seek to establish a pool of reserves by several countries. The latter proposal might be achieved through the strengthening of the already existing Latin American Reserve Fund (FLAR) and enlargement of its membership.⁶ It is worth noting that a fund like FLAR manages the reserves – which are protected by immunity – and also issues notes in the financial markets, so that its financing capacity is not strictly limited by the capital subscriptions of its members. Moreover, it benefits from good credit ratings, which are actually better than those of the sovereign debt of its member countries.⁷

In addition, the idea of using local currencies in intraregional trade activities has regained momentum. For instance, Argentina and Brazil have agreed to use national currencies for bilateral trade payments. Under this system – which at least initially will be optional – importers and exporters of both countries will pay to (or receive from) its central bank the amount due in domestic

currency at the daily exchange rate. Central banks will settle the outstanding balance at the end of each day. This mechanism will not only save hard currency in trade among the participant countries but it will also reduce the transaction costs for the firms, especially small and medium enterprises that must generally pay high fees for their international payments. It is likely to be extended to other South American countries through the LAIA payment system.

In the transition countries, small steps have been taken recently after the collapse of the Soviet Union led to monetary disintegration in the region. In the early 1990s, all CIS members introduced their own national currencies. Subsequently they embarked again on regional monetary cooperation to ensure that the *de jure* convertibility of these currencies could be translated into practice by a functioning market

Support for using local currencies in intraregional trade activities has gathered momentum.

for currencies. Furthermore, the International Association of Currency Exchanges of the CIS countries founded in 2000 and involving 20 stock exchanges in nine countries, aims at the creation of a common financial market through the harmonization of financial legislation, adoption of international standards, more extensive use of CIS currencies in regional trade as well as common exchange-rate policies. Since some member states have accumulated substantial amounts of foreign-exchange reserves in the past few years, it has also been suggested that further monetary cooperation might include the creation of a system of bilateral currency swaps to reduce vulnerability (Butorina, 2006: 106). However, installing such a system may be more difficult among CIS members than in Asia or Latin America, as long as there are no further advances in the creation of a common market.

C. Regional cooperation for development financing

1. Regional development banks

Regional development banks play an important role in regional financial cooperation. Some of these banks, including the Inter-American Development Bank (IDB) created in 1959, the African Development Bank (AfDB) in 1964 and the Asian Development Bank (ADB) in 1966, are North-South initiatives. These banks allocate credit to countries in the region based on contributions from both regional members and developed-country partners. The engagement of the latter gives them significant weight in the decision-making proc-

ess. For example, developed countries hold almost 50 per cent of the capital and voting power of the IDB (the United States and Canada alone accounting for 34 per cent), and 59.5 per cent of the capital and 54.2 per cent of the votes of the ADB. In the case of the AfDB, extraregional member countries – including some from West Asia, other parts of Asia and Latin America – hold 39.9 per cent of the voting power. On the one hand, the participation of developed countries facilitates these banks' access to the international financial markets. On the other hand, developing countries have to accept that control over these institutions is in the hands of developed-country members to a large

degree, and these rich members exert their influence through the voting distribution and other mechanisms (Culpeper, 2006: 43–44).

In addition to the World Bank and the North-South regional development banks, several financial institutions have been created at the subregional level, with a membership composed almost exclusively of developing countries. Subregional development banks have been created in Africa, in Latin America and in the Caribbean, as well as in West Asia and the Arab world, where, since the 1970s, they have channelled surpluses resulting from surges in oil export earnings into development financing. These institutions tend to give higher priority to financing genuine regional integration projects than the international financial institutions (World Bank, 2007: 3) (table 5.2).

A large proportion of the financing from these banks supports infrastructure projects, including energy, transport and communications. The largest share of the credits for sub-Saharan Africa from the AfDB and Arab and Islamic institutions is for agriculture and rural development. Again, debt issued by the subregional development banks obtains a better risk rating than sovereign debt issued by the country members. According to some observers, the good performance of these subregional banks in terms of the exceptionally low levels of non-accruing loans and high ratings by risk agencies is due mainly to the ownership of these institutions by developing countries – which confers on them a preferred creditor status – and their ability to adapt and respond to the specific needs of smaller countries and borrowers (Ocampo, 2006; Sagasti and Prada, 2006).

In addition, subregional development banks are increasingly financing the production of regional public goods in the areas of transport, energy and communications as they become involved in regional infrastructure initiatives such as the Puebla-Panama Plan and the Initiative for the Integration of South American Regional Infrastructure. Indeed, “they can provide member countries with a coordination mechanism through

which to plan and finance the provision of regional trans-border infrastructure and other regional public goods requiring large initial investments” (UN/DESA, 2005: 129).

Recently, some regional development banks have sought to enlarge their capital and access to international markets by incorporating new members, but without the original founders losing their control over the institution. Mexico, China, Argentina, Colombia and Spain have subscribed equity shares in the Central American Economic Integration Bank (CABEI). In a similar way, the Andean Development Corporation (CAF) issued special shares that were subscribed mainly by other Latin American countries⁸ and by private investors (mainly commercial banks) from the Andean Community (ANCOM). This enlargement of their capital allowed for an impressive expansion of credits: loans by CABEI rose from \$672 million in 2003 to \$3170 million in 2006; in the same period, credits approved by CAF increased from \$3300 million to \$5520 million, an increasing part of which is oriented toward Latin American members outside ANCOM. This trend may be deepening further, since some non-founding country members have announced their intention to expand their capital contributions to CAF significantly.

In addition, the Governments of Argentina, Bolivia, Brazil, Ecuador, Paraguay, Uruguay and the Bolivarian Republic of Venezuela have recently decided the creation of a new subregional development bank, the Bank of the South, one of whose main goals will be the financing of infrastructure projects supporting regional integration.

An increasingly important feature of regional development banks is their local currency exposure and portfolio. The ADB is the first regional development bank that strengthens local and regional financial markets both in its function as a borrower and as a lender by using local currency denominated instruments. With the explicit aim of reducing currency mismatches in its developing member countries and supporting local capital market development, the ADB has introduced its

A large proportion of financing from regional banks supports infrastructure projects, including energy, transport and communications.

Table 5.2

**REGIONAL DEVELOPMENT BANKS OUTSTANDING LOANS:
TOTAL AMOUNT, DISTRIBUTION AND DEBT RATINGS, 2005–2006**

Institution/region	Loans ^a	Destination by regions ^b		Distribution by main sectors ^b		Debt ratings ^c	
	(\$ million)	(Per cent)		(Per cent)		Long-term	Short-term
Latin America and the Caribbean							
Inter-American Development Bank incl. Fund for Special Operations (IDB)	53 047	South America	67.6	Energy	13.8	AAA	A1+
		Central America	24.9	Social investment	13.7		
		Caribbean	5.5	Transport and communic.	10.9		
		Regional operations	2.0				
Central American Bank for Economic Integration (CABEI)	3 179	Central America	100.0	Infrastructure	30.1	A-	A1
				Financial intermediation	30.0		
				Electricity	12.4		
Caribbean Development Bank (CDB)	1 126	Caribbean	98.3	Transport and communic.	26.4	AAA	A1+
		Regional operations	1.7	Finance and distribution	20.7		
				Multisector and other	18.1		
Andean Development Corporation (CAF)	7 347	Andean Community	89.1	Transport and communic.	37.4	A+	A1
		Other America and regional operations	10.9	Social and infrastructure	35.1		
				Electricity, gas and water	11.4		
Africa							
African Development Bank Group ^d	19 118	Sub-Saharan Africa	64.2	Agriculture and rural dev.	18.1	AAA	A1+
		North Africa	32.7	Transport	16.5		
		Regional operations	3.1	Multisector	15.2		
Ecovas Bank for Investment and Development (EBID Group)	54	West Africa	100.0	Infrastructure	65.6	..	..
				Agriculture and rural dev.	15.8		
				Energy	10.1		
Eastern and Southern African Trade and Development Bank (PTA Bank)	228	Eastern and Southern Africa	100.0	Manufacturing	25.9	..	..
				Infrastructure	22.1		
				Agribusiness	15.0		
Asia							
Asian Development Bank (ADB) and Asian Development Fund (ADF)	47 700	East and South-East Asia	57.0	Transport and communic.	23.1	AAA	A1+
		Central and South Asia	41.5	Energy	20.1		
		Oceania	1.4	Agriculture and natural resources	13.4		
		Regional operations	0.1				
Arab and Islamic institutions							
Arab Bank for Economic Development in Africa (ABEDA)	653	Sub-Saharan Africa	99.9	Infrastructure	52.2	..	..
		Regional operations	0.1	Agriculture and rural dev.	27.0		
				Energy	6.9		
Arab Fund for Economic and Social Development (AFESD)	6 313	West Asia	50.4	Energy and electricity	31.5	..	..
		North Africa	47.8	Transport and communic.	22.2		
		Sub-Saharan Africa	1.8	Agriculture and rural dev.	18.0		
Arab Monetary Fund (AMF)	1 086	North Africa	72.2	Balance-of-payments loans	74.2	..	..
		West Asia	19.7	Structural adjustments	19.8		
		Sub-Saharan Africa	8.1	Trade facilitation	6.0		
Islamic Development Bank Group (ISDB)	6 748	West Asia	36.3	Public utilities	26.0	AAA	A1+
		Other Asia	29.9	Social sector	22.7		
		North Africa	23.6	Transport and communic.	18.4		
		Sub-Saharan Africa	8.2				
		Rest of the World ^e	2.0				

Source: UNCTAD secretariat calculations, based on latest annual reports of concerned institutions; and Standard and Poor's (S&P), *Ratings in Products and Services*, at: www2.standardandpoors.com (accessed May 2007).

a Values correspond to the loan assets in the balance sheets as of end 2005, except IDB, ADB and ADF where data relate to 2006.

b The percentages concern either loan assets or cumulative approvals. Regional operations can consist of loans for regional organizations (economic cooperation and integration activities) or groups of countries. PTA's distribution by sector includes approvals (project financing) and loan assets (trade financing) in 2005.

c Ratings are from Standard and Poor's: AAA to BBB and A1 to A3 signify high quality credit and strong capacity to repay (long- and short-term respectively); BB to B (long-term) and B (short-term) indicate significantly speculative credit; CCC to C and C indicate vulnerability to non-payment; and D signifies default risk on both short- and long-term operations.

d African Development Bank, African Development Fund and Nigeria Trust Fund.

e Albania, Suriname, loans to Muslim communities in non-member countries, regional operations and special programmes.

local currency loan product. It has offered local currency loans since 2003, initially only to selected private borrowers but since 2005 to public sector entities as well. Furthermore, the ADB has issued local currency bonds of developing member countries and bonds in local financial markets of developing member countries. With the Indian rupee bond issuance in 2004, the ADB launched its first local currency bond on the domestic market of a borrowing member. This issuance was followed by similar transactions in Malaysia, China, the Philippines and Thailand.

Acknowledging the fact that making foreign currency-denominated loans to its clients from Latin America contributes to dollarization, the IDB has paved the way for local currency loans ever since September 2005. Already in 2004 the IDB, as the first institutional investor, had launched a global bond denominated in Mexican pesos that was available in the Mexican capital market. This was followed by bonds in Brazilian reals, Chilean pesos, Colombian pesos and Peruvian new soles. It was also issued in Hong Kong dollars, New Taiwan dollars and South African rand. Overall, 5 per cent of outstanding credit was denominated in developing-economy currencies in December 2006 (IDB, 2006a, IDB, 2006b). In a similar way, the Andean Development Corporation has issued bonds denominated in the currencies of member states.

The AfDB has provided its regional member countries with rand-denominated loans since 1997. After adopting a specific framework for lending in regional member country currencies, it is considering expanding its operations into regional capital markets, e.g. in Botswana, Ghana, Kenya, Mauritius, Nigeria, the United Republic of Tanzania, Uganda, Zambia and UEMOA. Accordingly, for the last 10 years it has issued rand-denominated bonds in the euro-rand market, albeit not in the South African market. At the end of 2005 the AfDB's first Botswana pula-denominated bond also qualified for the first true Eurobond in pula, which was followed by a Eurobond in Tanzanian shillings and Ghanaian cedi in 2006 (AfDB, 2007).

Subregional development banks in Africa, for instance the East African Development Bank, the East and Southern African Trade and Development Bank and the West African Development Bank, are important bond issuers in African capital markets, e.g., Kenya, the United Republic of Tanzania and UEMOA.

To the extent that such credit and payment mechanisms, along with mutual insurance through regional agreements, reduce the amount that each country must keep in liquid foreign assets for transaction and precautionary reasons, financial resources are freed for more productive uses. Some countries (mainly in Asia) are seeking to diversify their investment portfolios in order to increase their revenues and reduce the risks arising from asset concentration.

Regional financial cooperation might offer investment alternatives that would not only increase the financial returns on foreign reserve holdings but also enhance regional development.

Regional financial cooperation in the form of a regional investment fund based on hard currencies, or strengthening already existing regional financial institutions, might offer investment alternatives that would not only increase the financial returns on foreign reserve holdings but would also enhance regional development. As already mentioned, several South American countries have

already committed part of their international reserves to expanding their participation in subregional development banks and/or are considering the creation of a new regional bank – the Bank of the South, with the aim of promoting internal and regional integration.

Also in Latin America, the Bolivarian Republic of Venezuela, the country with the highest current-account surplus in the region, has diversified the use of its foreign exchange, in particular by providing financing to other Latin American countries. For example, it has acquired sovereign debt bonds issued by Argentina and Ecuador, and offers credit at very favourable conditions to countries importing its oil. It has also concluded an agreement with its associates in the Bolivarian Alternative for America (ALBA)⁹ which, besides setting special financial conditions for their imports of the Bolivarian Republic of Venezuela's oil, has created a number of joint-venture enter-

prises in the field of energy and a regional fund for financing development projects.

2. Regional bond markets

The development of regional bond markets is high on the agenda of policymakers and monetary authorities in many developing countries.¹⁰ The most sophisticated endeavour to deepen regional bond markets has been undertaken by the ASEAN+3 Finance Ministers, who launched the Asian Bond Markets Initiative (ABMI) in 2003. The ABMI is intended to develop more liquid primary and secondary bond markets and to recycle external surpluses into financing investment within Asia. To these ends, ABMI activities intend to address issues of market infrastructure in particular and of crowding-in a broader variety of issuers and investors into the national and regional bond markets. Six working groups have been established to work out studies and recommendations for improving bond markets, e.g., increased issuance of local currency bonds, improved capacity of local credit rating agencies or reduced foreign-exchange settlement risk to cross-border flows.

ASEAN+3's activities are complemented by the Executive Meeting of the East Asia-Pacific Central Banks group (EMEAP). EMEAP was established back in 1991 to deepen and strengthen cooperation between its members (EMEAP, 2003). During its initial phase, EMEAP was characterized by an informal consultation process; however, with increasing regional interdependence EMEAP began to formalize its structure by introducing three permanent working and study groups, e.g., the Working Group on Financial Markets, which prepared the ground for the formation of the Asian Bond Fund. It aims at deepening national and regional bond markets so as to reduce the dependence of Asian borrowers on short-term bank financing (EMEAP, 2006: 1).

Despite all these initiatives there has only been limited progress in the integration of regional financial markets. Between 1999 and 2005 the overwhelming majority of cross-border banking inflows to and outflows from ASEAN banks have

Table 5.3

PORTFOLIO INVESTMENT ASSETS, ASEAN AND ASEAN+3, 2001–2005

(Stocks in per cent of GDP)

	2001	2002	2003	2004	2005
ASEAN					
Portfolio investment	21.2	21.9	24.4	27.4	26.7
Equity ^a	6.3	6.0	6.8	8.2	8.8
Intra-ASEAN	1.6	1.4	1.2	1.9	1.7
Extra-ASEAN	4.7	4.6	5.6	6.3	7.1
Debt	14.9	15.9	17.5	19.2	17.9
Intra-ASEAN	0.8	0.9	1.5	2.2	2.0
Extra-ASEAN	14.1	15.0	16.0	17.0	15.9
ASEAN+3					
Portfolio investment	22.4	24.2	27.3	29.0	29.2
Equity ^b	4.2	3.9	4.6	5.6	6.1
Intra-ASEAN+3	0.2	0.3	0.3	0.4	0.4
Extra-ASEAN+3	3.9	3.7	4.3	5.2	5.6
Debt	18.3	20.3	22.6	23.4	23.1
Intra-ASEAN+3	0.5	0.4	0.4	0.5	0.5
Extra-ASEAN+3	17.8	19.9	22.2	22.9	22.6

Source: UNCTAD secretariat calculations, based on IMF, *Coordinated Portfolio Investment Survey (CPIS) Data*, at: www.imf.org/external/np/sta/pi/geo.htm (accessed May 2007); and *UNCTAD Handbook of Statistics* database.

- a** Data refer to Indonesia, Malaysia, the Philippines, Singapore and Thailand, which are the ASEAN countries included as creditors in the IMF database.
b Data refer to the creditor countries for ASEAN plus Japan and the Republic of Korea only.

been directed to other regions, in particular to Europe and North America (Cowen et al., 2006: 10). Cross-border portfolio investment by the five founding members of ASEAN and China, Japan and the Republic of Korea (ASEAN+3) shows a similar pattern. Total portfolio investment of both ASEAN and ASEAN+3 countries increased strongly to 27 per cent of GDP and 29 per cent of GDP respectively (table 5.3).

However intraregional portfolio investment, which is investment in equity and debt securities held by ASEAN and ASEAN+3 countries, amounts to only 3.7 of GDP and 0.9 of GDP respectively in 2005. In both groups, regional debt securities take a somewhat larger share of all cross-border

portfolio investment, but this share is still low. Obviously regional capital markets are better integrated than regional bond markets, in particular between ASEAN member states, which is reflected in a higher proportion of intraregional equities to total equities than intraregional bonds to total bonds for both ASEAN and ASEAN+3. This is where the activities of ASEAN+3 Finance Minis-

ters and the EMEAP Asian Bond Fund Initiative come into play. One of the major accomplishments of the ABMI initiative is the issuance of local currency bonds by the Asian Development Bank during 2005–2006 on six Asian bond markets, all with a maturity between three and five years, with two additional 10-year bonds in China and in Thailand (ABMI, 2006: 12).

D. Exchange-rate mechanisms and monetary unions

The last steps towards closer regional cooperation in the field of finance are the creation of regional exchange-rate mechanisms and monetary unions. On the global level, four regional monetary unions or strict exchange rate mechanisms exist. Three of them are to be found among developing countries: the Eastern Caribbean Currency Union (box 5.1), the Common Monetary Area in Southern Africa (CMA) and the Zone franc in Africa (CFA), which consists of two major groupings in francophone Africa. The Zone franc constitutes a monetary union between African countries and is the oldest existing North-South monetary arrangement. It is deeply embedded in the colonial past. The longest unaltered nominal exchange-rate peg with the French franc (now with the euro) links the Communauté Economique et Monétaire de l'Afrique Centrale (CEMAC), the Union Economique et Monétaire Ouest Africaine (UEMOA) and Comoros with France (see fig. 4.4).

Africa is home to another unusually long-standing and successful monetary coordination arrangement, namely, the Common Monetary Area (CMA). In contrast to the Zone franc member countries, CMA member states apply a nominal peg within the region and a common managed float

vis-à-vis all other currencies. All members of the CMA are also part of the oldest existing customs union in the world, the Southern African Customs Union (SACU), dating back to 1910. All SACU countries are also members of the Southern African Development Community (SADC), which has launched an ambitious programme for regional integration whose goal is a common market and monetary union. The Gulf Cooperation Council is also envisaging the creation of a monetary union by 2010 (see annexes to this chapter).

The largest regional monetary union is located in Europe, including only developed economies as member states. The European integration experience is a unique case in which regional cooperation has progressed during more than 50 years, with monetary union being reached after 30 years of a variety of exchange-rate mechanisms. The European Monetary Union and its predecessor, the European Monetary System, are often considered as models of cooperation and success. However, some hesitation is justified when considering the flaws of the process, the role of the regional anchor currency and the monetary regime applied by the European Central Bank and its predecessors.

Box 5.1

THE EAST CARIBBEAN CURRENCY UNION

The East Caribbean Currency Union (ECCU) is a monetary union composed of eight small-island economies, six of which are independent states (Antigua and Barbuda, Dominica, Grenada, Saint Kitts and Nevis, Saint Lucia and Saint Vincent and the Grenadines), while the remaining two are British overseas territories (Anguilla and Montserrat). All these economies, together with the British Virgin Islands, constitute the Organization of Eastern Caribbean States (OECS). In June 2006, the OECS joined the CARICOM Single Market (CSM).

The predecessors of the ECCU were the British Caribbean Currency Board (BCCB, 1950) and the Eastern Caribbean Currency Authority (ECCA, 1965). The latter was created after the withdrawal of Trinidad and Tobago and British Guyana from the BCCB. The ECCA issued a currency that was initially pegged to the pound sterling. In July 1976, the peg was transferred to the US dollar at the parity of 2.70 East Caribbean dollars to 1 dollar. This parity has not changed since (ECCB, 2004).

In 1981, the OECS decided to replace the Eastern Caribbean Currency Authority with a regional central bank, the Eastern Caribbean Central Bank (ECCB), which issues the currency, conducts monetary policy and supervises the financial system; it has been in operation since 1983. It is headed by a Monetary Council comprised of one minister appointed by each of the eight member governments, and by a Board of Directors – the Governor and Deputy Governor along with one Director appointed by each participating country. The ECCB operation is close to that of a currency board, since it maintains a hard peg and has to back at least 60 per cent of its monetary base with international reserves; it preserves itself a room for manoeuvre however, as its mandate is not only to maintain monetary stability but also to promote development and regional integration. In December 2006, the ECCB had abundant liquidity, with international reserves representing 99.6 per cent of its demand liabilities (ECCB, 2007: 7).

The currency union seeks to provide a wider unified space for the development of a modern and efficient financial system. This not only includes harmonised banking legislation and joint regulation but also the creation of key regional financial institutions and markets: the Eastern Caribbean Home Mortgage Bank, the Eastern Caribbean Institute of Banking and Financial Services, the Eastern Caribbean Securities Exchange, the Eastern Caribbean Securities Market and the Regional Government Securities Market. With the unification of the eight former segmented bond markets, fiscal policy intended to reduce the cost of borrowing and to deepen regional financial markets by making primary bond markets more attractive for domestic and international investors. Turnover on the regional government securities market increased seven-fold between 2002 and 2006, and the share of foreign debt in total public debt could be reduced.

Strengthening the financial sector has a prominent place in the development strategy of the ECCU economies, especially as their agriculture sector is affected by the reduction of preferences delivered by the European Union to the exports of banana and sugar. This strategy aims to develop offshore finance further, an objective for which currency stability, low inflation and the solvency of financial intermediaries are essential as they preserve investor confidence. The strategy also intends to expand domestic credit through a network of development financial institutions for servicing small, medium and micro enterprises (ECCB, 2007: 3).

The currency peg has been the cornerstone of monetary policy and has provided the anchor for low inflation rates. Its maintenance requires rising exchange inflows from tourism and FDI (mostly related to tourism), in order to reduce or to finance a current account deficit that is close to 20 per cent of the region's GDP. At the same time, the currency peg could be threatened by persistent fiscal deficits and a public debt exceeding 100 per cent of GDP, which could trigger a movement to challenge the East Caribbean dollar. Fierce competition for attracting FDI has pushed governments to offer tax incentives, especially in the form of extended tax holidays, with a cost in terms of fiscal revenue that was estimated at between 10 and 16 per cent of GDP (IMF, 2007: 19). In a situation characterised by falling revenues from trade taxation, these generous concession regimes pose a policy dilemma with regard to conflicting goals concerning fiscal and external accounts. It would be desirable that, as part of policy coordination within OECS and CARICOM, a common incentive regime be adopted, thus "limiting the degree to which investors (can) induce governments to compete against each other" (IMF, 2007: 19; see also *TDR 2005*, chap. III).

1. Experiences in Africa

(a) *The Common Monetary Area in Southern Africa*

The Common Monetary Area (CMA) is based on a tripartite arrangement between Lesotho, South Africa and Swaziland, at that time known as the Rand Monetary Area, which came into effect in 1974 (Namibia joined later in 1992) (Metzger, 2006). The agreement formalized existing de facto monetary integration, as the South African currency had been serving as legal tender in Lesotho and Swaziland since the 1920s. The CMA agreement provides for fixed exchange rates among its members and common bloc floating vis-à-vis other currencies as well as intraregional capital account liberalization, the distribution of seigniorage and some intraregional financial transfers. Both the Lesotho loti and the Namibian dollar are pegged at par to the South African rand. Although Swaziland legally withdrew from this commitment in 1986, it is still honouring it de facto. Botswana participated in the CMA negotiations in the 1970s but it opted out in favour of a managed floating of its currency, the pula. Since then, however, Botswana has pegged the pula to a basket whose composition is not displayed. However it is assumed that the basket, which is adjusted from time to time, includes the South African rand as a major part. Each of the four members has its own central bank, which issues its currency and is formally responsible for monetary policy within its respective country.¹¹ However, since the rand functions as the regional anchor currency, the South African Reserve Bank determines monetary policy for the CMA member countries via its interest rate policy.

Under the CMA arrangement, South Africa shares the seigniorage of the rand with Lesotho and Namibia. Although the South African rand still serves as legal tender in both these countries, none of the other currencies are legal tender in South Africa or are commonly used there. Swaziland does not participate in the seigniorage since it abolished the legal status of the rand in 1986.

Another important element of the arrangement is that the South African Reserve Bank acts as a lender of last resort for Lesotho and Namibia with a view to ensuring financial stability in the CMA. Moreover, member countries can draw on a pool of foreign-exchange reserves that is managed by the South African Reserve Bank. Lesotho, Namibia and Swaziland may hold additional foreign exchange for direct and immediate needs, of which up to 35 per cent may be held in currencies other than the South African rand. Their central banks and authorized dealers have free access to the foreign-exchange market in South Africa. Finally, while there are no restrictions on capital movements within the CMA, a common exchange control system vis-à-vis the rest of the world is administered by the South African Reserve Bank in cooperation with the central banks of the other members.

The only intraregional institution, apart from a technical committee, is the Common Monetary Area Commission. It is composed of one representative and advisers from each member state, and provides a formal consultation mechanism on monetary and financial policies. It meets prior to the Monetary Policy Committee of the South African Reserve Bank, which determines interest rates for South Africa and, via the peg, also for the other CMA countries. In 2005, central bank governors of the region analyzed the costs

and benefits of a common central bank for the CMA countries. However, no decision has yet been taken and when it will be taken depends on the performance of the common institutional structures recently created in SACU.

Due to the currency peg and to instruments akin to those of a monetary union, the financial sector within the CMA is highly integrated. However, financial relations are organized in a hub-and-spoke system, with South Africa at the centre. A capital flows survey conducted by the Central Bank of Lesotho (1996) revealed that one quarter of all customers of commercial banks in that country also had bank accounts in South Africa and that more than 40 per cent of households intended to open such accounts; another 20 per cent of domestic firms and households disclosed

Under the CMA arrangement, South Africa shares the seigniorage of the rand with Lesotho and Namibia.

that they were holding financial assets in South Africa. These figures are likely to have increased since the mid-1990s. The banking sector in particular, which accounts for a major part of the financial sector, is highly concentrated in terms of ownership. The South African banking sector is dominated by four South African commercial banks, with a combined market share of about 90 per cent. A similar concentration exists in Lesotho, Namibia and Swaziland; in these countries ownership of the major banks is also mainly South African.¹² Although the three countries might find it difficult to issue bonds or raise loans in domestic currency, they have free access to the South African credit and bond markets, where they are able to issue bonds and raise loans denominated in rand. Yet, overall, South Africa is a net debtor vis-à-vis the other member countries of the CMA (South African Reserve Bank, 2007). Net liabilities are due to deposits in the South African banking sector, as in the case of Lesotho and Swaziland, or due to holdings of South African debt securities by Namibian creditors.

CMA membership has resulted in a process of convergence of real growth and inflation rates. With regard to monetary convergence, the most important goal has been to reduce inflation to the South African level. The central banks of the three smaller member economies adjust their interest rates to defend the nominal exchange-rate peg and thereby “import” price stability. Although the deepening of the financial sector in Lesotho, Namibia and Swaziland is limited due to small market size, since 2000 the latter two middle-income countries either have the same or even slightly lower nominal short-term central bank interest rates than that prevailing in South Africa, while Lesotho’s nominal interest rate level has been converging with the South African benchmark since 2005.

Overall, real interest rates in the CMA countries have been rather high in relation to growth rates. This was due mainly to the fact that the anchor country, South Africa, had to fight with current-account deficits as well as relatively high wage growth and boom-bust cycles of deprecia-

tion and appreciation of its exchange rate. However, compared to other small African countries external volatility was relatively limited and the ability of CMA members to use the regional anchor currency for bond and loan contracts – rather than one of the major reserve currencies – brought other advantages.

Since the 1970s there has been a clear trend towards business-cycle convergence among CMA countries. Variations in real GDP growth rates have been reduced not only across CMA countries but also over time within each country.¹³ Beyond intraregional trade flows remittances by migrant workers have played a role as transmission channel for real convergence. South Africa employs many migrants from CMA countries, especially in mining and agriculture. Higher growth in the South African mining industry increases the demand for migrant workers, their incomes and their remittances and vice versa.¹⁴

Given the geographical proximity and the dominance of the South African economy, regional integration between these four countries would have occurred even without formal regional cooperation agreements. However, the formal agreements have allowed Lesotho, Namibia and to a lesser extent Swaziland to share the benefits of this integration better. Without a formal agreement, these economies would most likely have experienced an uncontrolled process of “randization” similar to “dollarization” in Latin America or “euroization” in many of the economies of Central and Eastern Europe. Such processes expose countries to the risk of serious liquidity crises or misalignment of the real exchange rate.

Additionally, without the regulatory framework for monetary and financial relations created by the CMA agreements, the smaller countries would have been obliged to resort to restrictive monetary and fiscal policy time and again to defend their currencies and check capital flight to South Africa, a policy that has proved harmful for development in many other developing and transition countries (*TDR 2006*, chap. IV). Furthermore, intraregional competitive devaluations are ruled

CMA membership has resulted in a process of convergence of real growth and inflation rates.

out by the common bloc floating vis-à-vis the rest of the world. Thus negative balance sheet effects for the rand-denominated debt of Lesotho, Namibia and Swaziland are prevented. Consequently, the region displays an unusually high degree of monetary and exchange-rate stability, which has allowed Lesotho, Namibia and Swaziland to grow gradually out of a net debtor status to that of a net international creditor.

(b) *The CFA franc zone*

The establishment of the CFA franc zone dates back to 1945. The creation of a common currency for the former French colonies, the CFA franc, was intended to protect these African countries from the effects of any depreciation of the French currency vis-à-vis the dollar under the Bretton Woods arrangements. The CFA franc was pegged to the French franc until 1999, and thereafter to the euro. In more than 60 years of the arrangement, the parity has changed only twice: in 1948, the CFA franc was re-valued by more than 17 per cent against the French franc and in 1994 it was devalued with the effect that the parity increased by exactly 100 per cent.

The economic deterioration that forced this dramatic devaluation led to the formation of two sub-groupings, each with its own common central bank: the Economic and Monetary Community of Central Africa (CEMAC) and the West African Economic and Monetary Union (UEMOA). As a result, two currencies were circulating in the CFA zone before the introduction of the euro: the franc of the Communauté Financière d'Afrique in West Africa and the franc of the Coopération Financière en Afrique Centrale in Central Africa. The two currencies are set at parity to each other but the use of each is restricted to their respective sub-region. The two sub-groupings were intended to deepen regional integration and strengthen harmonization between the policies of their member countries.¹⁵ However, each of them belongs to different regional integration schemes: CEMAC forms the

major part of the Economic Community of Central African States (ECCAS) and all UEMOA states are members of the Economic Community of West African States (ECOWAS).

The CFA franc zone has adopted three main monetary instruments. First, France guarantees the convertibility of the CFA franc, which is issued by the central bank of each sub-group. In exchange, the central banks of CEMAC and UEMOA deposit at least 50 per cent¹⁶ of their foreign-exchange reserves, converted to euro (formerly to French francs), in an account at the French Treasury. Second, the French Treasury compensates CFA zone members for any depreciation of the euro (formerly the French franc) against the special drawing rights (SDRs) and pays interest to the central banks of the countries of the CFA zone on their deposits. Third, in order to maintain financial stability, the Banque de France acts as a lender of last resort. In principle, the French Treasury gives all zone members unlimited overdraft facilities with progressively increasing interest rates. In exchange, CFA zone member countries are required to have foreign-exchange reserves at

their disposal equivalent to at least 20 per cent of their monetary base. Furthermore, credit from the two respective central banks of CEMAC and UEMOA to a member country must not exceed 20 per cent of that country's public revenues of the preceding year. Though crucial for the sustainability of the exchange rate, bilateral aid from France is not an instrument

agreed upon between CFA zone member countries and France but is at the unilateral discretion of France.

In terms of price stability the performance of CFA zone members has been far superior to that of most non-CFA zone countries in Africa. Annual consumer price inflation averaged 8 per cent during the period 1960–2004, and its variation within the CFA franc zone averaged 10 per cent, compared to non-CFA Africa where average annual inflation was 75 per cent and the inflation rate variation was more than 230 per cent (Yehoue, 2007; Nnanna, 2006). However, as France introduced a resolute “*franc fort*” policy in the early

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Table 5.4

REAL EFFECTIVE EXCHANGE RATE, FRANCE, CEMAC AND UEMOA, 1990–2006						
(Index numbers, 2000 = 100)						
	1990–1993 ^a	1994	1995–1999 ^a	2000	2001–2005 ^a	2006
France	111	112	111	100	105	108
CEMAC ^b						
Cameroon	154	97	109	100	108	113
Central African Republic	152	94	107	100	118	129
Equatorial Guinea	137	97	111	100	129	151
Gabon	173	103	111	100	102	105
UEMOA ^b						
Côte d'Ivoire	144	89	103	100	112	116
Togo	132	87	104	100	108	112

Source: UNCTAD secretariat calculations, based on IMF, *International Financial Statistics* database.

a Period average.

b Data were not available for other member countries of CEMAC and UEMOA.

1980s in an attempt to converge with the most stable economies in the European Union (EU), these low inflation rates (by developing-country standards) at the time were not low enough to prevent overvaluation vis-à-vis the French franc and the currencies of other Western European countries. However, the sharp devaluation in 1994 corrected the overvaluation, which had been accumulated in the years before (table 5.4).

In the aftermath of the devaluation in 1994, UEMOA countries reduced their average annual inflation rates even further to 2.6 per cent in the period 1996 to 2005 (IMF *International Financial Statistics* database). Although CFA franc zone countries slashed their inflation rates down to almost European levels only two years after the devaluation, this competitive advantage levelled out in 2000 and was replaced by incremental revaluation compared to France, with the notable exception of Gabon. Growth in the CFA zone has picked up recently mainly due to rising oil prices and the prices of other mineral and mining products exported from the region.

Financial integration within UEMOA has been limited mainly to cross-border transactions

in the growing government bond market, to which commercial banks channel much of their excess liquidity (Sy, 2006). The regional capital market is small and the regional inter-bank market rudimentary. Although French presence in the regional banking market is still strong, subsidiaries of French banks have been losing market shares to African banks having an explicitly regional approach. For example ECOBANK, which has branches in 13 countries of the region, has become the largest trans-national bank operating in the CFA franc zone. However as with GDP and trade volume, 50 per cent of regional banking assets in UEMOA are concentrated in Côte d'Ivoire and Senegal (Sy, 2006).

A process of regional surveillance over macroeconomic convergence was set in motion when UEMOA agreed upon a Convergence, Stability, Growth and Solidarity Pact in 1999. Both UEMOA and CEMAC adopted convergence criteria including an inflation target of 3 per cent, a balanced budget (excluding official development assistance (ODA)) and a maximum limit for total public debt set at 70 per cent of GDP (Banque de France, 2005; Comité de Convergence, 2007). Although there has been some success in convergence with re-

gard to the formal criteria, convergence in terms of GDP growth rates and reduction of regional social and economic disparities between UEMOA member countries has been limited and is almost non-existent within the CEMAC.

As in SACU, remittances are an important channel of convergence among UEMOA members. For example, over 40 per cent of workers' remittances to Burkina Faso originate in other UEMOA member countries, in particular Côte d'Ivoire (Banque de France, 2005), and around many workers in Côte d'Ivoire come from other UEMOA countries, in particular Burkina Faso and Mali (van den Boogaerde and Tsangarides, 2005). Whereas UEMOA is a net recipient of remittances, there is a net outflow of remittances from CEMAC countries to the rest of the world due to numerous skilled employees from industrialized and other developing countries working in their oil industries. Intra-regional remittances accounted for only 10 per cent of total gross remittances in CEMAC in 2005 (Banque de France, 2005).

Formal cooperation and regional institutions have had mixed results in terms of regional integration in the CFA franc zone. Various common regulatory frameworks to facilitate intra-regional trade and financial flows have been initiated, and economic actors seem to be taking advantage of the resulting opportunities. For example, since UEMOA established a customs union and liberalized intra-regional trade in 1999, the share of intra-regional trade in total trade has been increasing, although from a low level, and so far without a visible impact on industrialization and diversification.

To prevent a loss of competitiveness of their domestic industries on the European market, CFA zone members have to adjust their inflation rates to the euro zone level of 2 per cent, which may be quite tight for a low-income developing country undergoing rapid structural change. There are also other disadvantages to unilateral fixing. In the case of a euro appreciation, the loss of competitiveness on Asian markets or within the dollar area could even provoke region-wide deflation – which would be particularly dangerous for low-income countries seeking to develop their manufacturing capacities. Thus CFA zone countries have suffered time and again from the drawbacks of very rigid

nominal exchange rates vis-à-vis their European trading partners and the rest of the world without having derived many benefits from exchange-rate stability because of the relatively low level of intra-regional trade, especially in manufactures and services that are more exchange-rate sensitive than primary products.

Apart from their pro-cyclical character, stringent fiscal convergence criteria such as a balanced budget (without ODA) or even a budget surplus have not been conducive to the process of financial integration within the CFA franc zone either. This is because financial markets in both the sub-groups of the CFA zone consist mainly of public entities and commercial banks, with the former issuing domestic debt and the latter purchasing treasury bills and other public bonds. If the governments of the CFA zone countries were to abstain permanently from borrowing in their domestic or regional markets, the possibility of developing financial markets would be severely curtailed.

More generally, the choice of convergence criteria and quantitative targets is a delicate matter because the targets set in Europe are based on expectations formed under specific macroeconomic and market conditions. The Convergence, Stability, Growth and Solidarity Pact of UEMOA foresees that an initial convergence phase would be followed by a stabilization phase, which was originally scheduled for the period 2000 to 2002. However, the end of the convergence phase has already been postponed twice. Thus instead of enhancing credibility in regional institutions and in the process of regional integration, the Pact might even put in question the credibility of the whole project and of member countries' governments.

(c) *African lessons*

Monetary and exchange-rate policy has been by far the most developed area of regional cooperation and integration in Africa. With the two currency unions of CEMAC and UEMOA, nominal exchange-rate stabilization within CMA and the prospective currency unions of SADC and West African Monetary Zone (WAMZ), Africa has

taken the lead in the developing world in terms of regional monetary integration. Nominal pegs seek to establish price stability at the level of the anchor currency and to import credibility in exchange-rate stabilization. This has already materialized for the members of CEMAC, CMA and UEMOA. The SADC and WAMZ countries are on their way to achieving price level convergence, although with mixed results due to different exchange-rate regimes. Thus the African experience with regional monetary cooperation shows that the adoption of a common exchange-rate regime may help reduce and contain the domestic inflation rate and its variation between individual countries and the regional grouping as a whole. As the converse does not hold – harmonization of inflation does not necessarily lead to stable nominal intraregional exchange rates – stabilization of the nominal exchange rate requires some form of managed fixing or managed floating at the regional level or even beyond.

Monetary and exchange-rate policy has been the most developed area of regional cooperation and integration in Africa.

The greatest handicap of exchange-rate based stabilization is the risk of an appreciation of the real exchange rate due to positive inflation differentials between the domestic and anchor currencies. Such real appreciation results in a shrinking of net exports and in a deterioration of the current-account balance. This can put the nominal anchor at risk, as was experienced by many developing countries in Asia and Latin America. However, intraregional overvaluation among CMA countries, as well as between CEMAC and UEMOA, has been moderate. But, although inflation rates in CFA zone countries have been strikingly low compared with other developing countries, overvaluation vis-à-vis the rest of the world has been devastating. The peg to the French franc, and subsequently to the euro, resulted in a major disincentive for CFA zone countries' exporters of both raw materials and processed goods. Thus a peg to a regional currency seems to be superior to a peg to an international key currency.

Stabilization of nominal intraregional exchange rates and common-bloc floating with the rest of the world as practised by CMA countries can imply vulnerability for extraregional trade if

the anchor currency is subject to speculation after the dismantling of capital controls, as was the case in South Africa (see chap. I). The exchange rate of the rand has been highly volatile, as were the exchange rates of the smaller CMA countries vis-à-vis the rest of the world. By contrast, a nominal peg to an international key currency is expected to reduce vulnerability for extraregional trade but the experience of the CFA zone countries has shown that in such an arrangement the exchange rate of the developing partner can be subject to volatility if the anchor currency swings as much as the euro did vis-à-vis the dollar. Thus the two different forms of pegs are almost equally disadvantageous with regard to any exchange-rate volatility caused by extraregional factors. Pegging to an international key currency, however, may involve much more ambitious targets for monetary and fiscal policy than pegging to a regional partner.

2. *The case of the European Monetary Union*

(a) *The end of disintegration after the war*

The European integration experience is a unique case, in which monetary cooperation has progressed during more than 50 years through all the steps from simple clearing arrangements to full monetary union. In this process, real integration went hand in hand with monetary cooperation. As a consequence, European determination to go step-by-step in the direction of a monetary union and a political union is seen as a model by many other regions facing similar challenges. However, it should not be forgotten that the conditions – both economic and political – to achieve such a result are simply not replicable and that European integration has now reached a critical juncture. The beginning of the integration process dates back to the end of the Second World War and in many respects European integration is a child of the Cold War (Holtfrerich, 2007). It was only after the confrontation between East and West emerged that

European politicians were willing to join forces and integrate the Western part of their wartime enemy, Germany.

Nevertheless, agreement among the Western European states that economic integration was necessary and would benefit all participants was rather easy to find. Belgium and Luxembourg had already formed a customs and monetary union in 1922 and agreed on a customs union with the Netherlands in 1947. Denmark, Sweden, Norway and Iceland considered forming a customs union in 1947, as did Greece and Turkey in the same year. The British government began negotiations with Sweden, Norway and Denmark in 1949 for a regional economic union. And France started negotiations in 1948 with Italy and the Benelux countries on an economic association for free trade and decontrol of foreign exchange. Only the Benelux customs union, however, reached the stage of implementation.

On the other hand, Western European countries were too heterogeneous for full political unification. The new principle, therefore, was a gradual approach: nation states should move in the direction of the final goal step-by-step and give up national sovereignty when and where it was acceptable to them. A limited transfer of sovereignty to a supranational institution would suffice for the time being to disentangle the problems of free access to Germany's coal resources and would integrate Germany into Western Europe on an equal footing, including with regard to European reconstruction. In 1957, the Treaty of Rome was signed instituting the European Economic Community (EEC). It aimed primarily at the free exchange of industrial goods and demanded an integrated foreign trade, transport and competition policy as well as a Common Agricultural Policy. Trade integration and a dismantling of trade barriers was the main target of the EEC dur-

ing the 1960s, as Europe was closely tied financially to the United States through the Bretton Woods monetary system.

When that system faded away in the early 1970s, financial stability stood high on the European agenda as a necessary complement to efficient trade relations. With closely integrated markets, members of the EEC had a strong interest in avoiding short-term exchange-rate instability between their currencies that would seriously compromise the functioning of markets; in particular, it would affect the organisation of the common agricultural market that relied entirely on a common price policy.¹⁷ As a result, in April 1972 the European countries established a framework for limiting exchange-rate fluctuations among their currencies to ± 2.25 per cent ("the snake") within a band of ± 4.5 per cent to the dollar ("the tunnel"). With the floating of the dollar in 1973 the arrangement was reduced to a common float. Member countries were required to intervene with Community currencies to defend the internal margins of the "snake". At the outset, all EEC founding members participated in this arrangement. However, with increasing capital flows and oil price hikes in the 1970s, fluctuations of member currencies steeply increased and member countries found it more and more difficult to reconcile domestic macroeconomic policy requirements with exchange-rate discipline.¹⁸

In the late 1970s, with growing real integration and initiatives for greater political cooperation, Germany and France took the initiative to head for a much more comprehensive approach to European monetary integration. The newly-established European Monetary System (EMS) became effective in 1979 and, with some modifications, operated until the creation of the European Monetary Union in 1999. The EMS introduced fixed but adjustable exchange rates for the mem-

The European integration experience is a unique case, in which monetary cooperation has progressed for more than 50 years.

In the late 1970s, with growing real integration and initiatives for greater political cooperation, Germany and France took the initiative by heading for a much more comprehensive approach to European monetary integration.

ber countries of the European Union. A nascent form of common currency was created, the European Currency Unit (ECU): central banks participating in the EMS pooled together 20 per cent of their reserves in gold and dollars in the European Fund for Monetary Cooperation (EFMC); in exchange, the EFMC issued ECUs, which served for payments among the participating central banks.

(b) *The European monetary system*

The core of the design of the EMS was the *parity grid*, a matrix of bilateral exchange rates vis-à-vis all the other ERM currencies. Until the 1992–1993 EMS crises, bilateral parities could move within a band of ± 2.25 per cent (for the Italian lira of ± 6 per cent), while after the crisis the band was widened to ± 15 per cent for all exchange rates. The symmetry of the bilateral parities implied that when currency A reached its *upper* intervention point (or depreciated) vis-à-vis currency B, currency B would simultaneously reach its *lower* intervention point (or appreciate) vis-à-vis currency A. Thus a currency pair drifting to its band limits implied that two central banks would be obliged to intervene.

Central banks could finance their interventions with very short-term financing. Within this mechanism each central bank opened an unlimited credit facility to all the others, but credits had to be repaid by the debtor central bank in assets other than its own currency, in principle six weeks after the end of the intervention month.¹⁹ Thus, the central bank of the currency under threat of depreciation operated under a strict budget constraint and if the pressure continued was faced with the option of raising interest rates or devaluing. In contrast, interventions of the country with an appreciating currency actually increased its ECU balances and did not result in any pressure to change its policy stance. Hence the symmetry of the adjustment mechanism was only formal, since a speculative attack never changed the monetary policy stance of the strong-currency country but always forced substantial increases in short-term rates of the countries with weak currencies.

When the EMS came into operation its eight participants were rather heterogeneous in terms

of country size, per capita income, trade openness and macroeconomic fundamentals.²⁰ Thus the members did not meet the theoretical requirements for an “optimum currency area”. Convergence, in particular in monetary issues, was understood as a process that intraregional exchange-rate stability could help bring about. Given the credibility of Germany’s central bank and its extraordinary inflation performance, high-inflation EMS members used a stable nominal mark exchange rate as an external anchor to bring down domestic inflationary expectations at a time when, immediately after the second oil price explosion, inflation was a serious problem for most oil-importing countries.

During the first half of the 1980s, traditionally high-inflation countries had to depreciate time and again in order to restore their competitive position. However, the second half of the 1980s brought significant inflation convergence to the German level. The target of the European Council to create a “zone of monetary stability in Europe”, implying both relatively stable domestic price levels and stable exchange rates, seemed to have been achieved. While there had been 11 realignments up to 1987, no realignment occurred until the EMS crisis of 1992–1993. However the EMS, as every fixed exchange-rate system, was prone to the overvaluation of member states currencies and to speculative attacks.

The *nominal* exchange rate paths that the EMS members targeted vis-à-vis the mark were associated with very different real exchange-rate paths and competitive positions. While France, Denmark and the Benelux countries maintained a relatively stable real exchange rate vis-à-vis the mark, other member countries experienced massive real appreciations before 1992–1993 due to rising unit labour costs. The accumulated loss of competitiveness between 1987 and 1991 eventually amounted to 23 per cent for Italy and 28 per cent for the United Kingdom. This was reflected in a huge swing in their current accounts from surpluses to deficits.²¹ This obviously unsustainable constellation triggered speculative attacks on the three big EMS currencies outside Germany.

When the tide of the global economy had turned in 1990, monetary policy in the United States quickly stepped in and lowered its interest rates. Germany’s economy, however, stimulated

by a unique boost of demand from the Eastern part of the country after its unification, did not show any sign of a slowdown. The German central bank eventually decided to stop the overheating of the economy by all means: it pushed policy interest rates in Germany to a high of 8 per cent in the summer of 1992, sending shock waves around the world and showing “utter disregard” of the policy impact on its European partners (Buiter, Corsetti and Pesenti, 1998: 41).

The big EMS crisis in 1992–1993 was solved by floating the British pound and by a sharp devaluation of the Italian lira. Italy temporarily resigned from the system and the United Kingdom completely retreated.²² The French franc, despite being subject to fierce speculative attacks, did not devalue; it only widened its band in 1993 to ± 15 per cent.

In fact, France insisted that it had been playing within the rules of the game and deserved the kind of symmetric treatment that the letter of the European treaties had promised. Eventually France’s insistence proved to be justified. France, not unlike Austria and the Netherlands, had been able to preserve its competitive position after entering the EMS. The fact that France had been coming under pressure in the financial markets did not prove that its external situation was unsustainable. Notabene, its overall economic situation at the time was gloomy compared to Germany or Austria and depreciation would have been an easy way out of recession. However, the decision of the French government to insist on sticking to the “unwritten” rules of the game (using depreciation only in the case of an *external disequilibrium*) was confirmed in the end. In other words, the markets got it wrong in the French case whereas for the United Kingdom and Italy the attack was justified. The bold move of the French authorities to challenge the wisdom of the market proved to be right: The band was widened formally but the core rate of the French Franc never changed till it entered the EMU.

The 1992–1993 currency crisis in Europe highlighted the role that governments and central banks have to play by monitoring and steering the

system. Moderating capital flight out of the pound, the lira and the franc was justified in any case. However, thorough analysis of the fundamentals of the economies involved revealed that there was a need to adjust the pound and the lira to a certain extent but no need at all to adjust the franc. There was no reason to fear panic or a total collapse of the EMS.

The crisis phenomena and the waves of speculation occurring frequently in systems of fixed and semi-fixed exchange rates could give rise to the impression that an anchor approach to stabilize the external and the internal value of money is counterproductive in most cases. How-

ever, this is not always true. For instance, anchoring a small and very open country’s currency has in several cases proven to be a very effective method of stabilization of the domestic price level. The main economic policy target many anchoring countries had in mind was not the external value of money but its domestic value. Here is where the approach of “tying

your own hands” has proven to have its merits time and again.

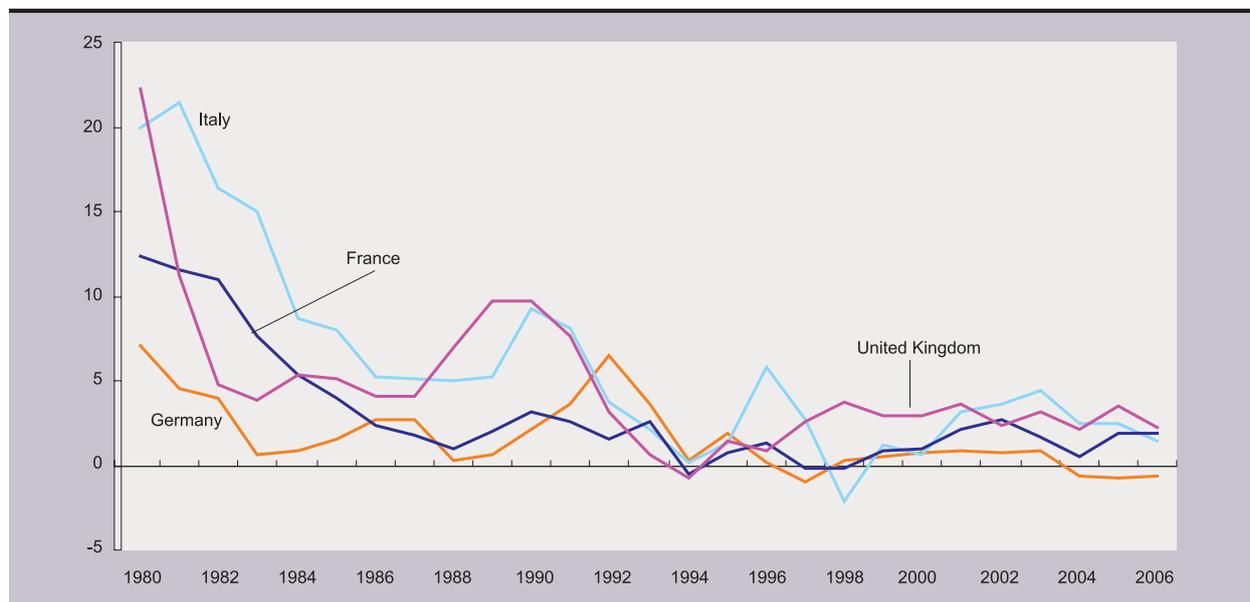
This is definitely true for the small anchoring countries in Europe like Austria, the Netherlands and Belgium. In these countries inflation has been subdued for decades now in the same way as in their anchor country Germany and they have been able to adjust to shocks just as effectively. Moreover, the anchor approach has been successful in some larger countries like France and Italy as well. Although France fixed its exchange rate later than the smaller countries and the adjustment was not always as smooth, France managed to catch up fully with German inflation performance. Even a country like Italy, which was the subject of many speculative attacks and many backlashes in its adjustment process, finally converged in terms of growth rates of unit labour costs and flexibility in case of shocks. The growth rates of unit labour costs over time demonstrate the enormous convergence performance of the European countries (fig. 5.1)

Given the fact that recently the United Kingdom and the United States, i.e., countries with flexible exchange rates, have also been success-

The 1992–1993 currency crisis in Europe highlighted the role that governments and central banks have to play in monitoring and steering the system.

Figure 5.1

NOMINAL UNIT LABOUR COSTS, SELECTED EUROPEAN COUNTRIES, 1980–2006
(Annual percentage change)



Source: UNCTAD secretariat calculations, based on AMECO database.

Note: Data are for the total economy in national currency. 1980–1991 data for Germany refer to West Germany.

ful in terms of the speed and sustainability of their adjustment to shocks, the question arises as to whether this success has to be attributed mainly to the anchor approach or to other factors. Of course, Western industrialized countries have developed a variety of institutional arrangements concerning the labour and the goods markets to stabilize the internal value of money. Very different arrangements have proven successful in doing the job. However, for some countries' economies external pressure, e.g., pressure coming through the import and export channel, has been superior to domestic economic policy pressure alone. Italy is the most prominent example of a relatively large country where the domestic institutional framework has hardly ever been sufficient to stabilize monetary conditions.

The situation of candidates for membership in the European Economic and Monetary Union (EMU) changed dramatically one more time before 1997, the year in which the membership criteria, as decided by the European Council and laid down in the Treaty of Maastricht (1993), be-

came effective. Potential members had to adhere strictly to the so-called Maastricht criteria, limiting their control over macroeconomic policy submitting to expenditure cuts or tax increases in their public budgets. In addition, they had to fix their exchange rates absolutely, which meant in fact to follow the Bundesbank's monetary policy strictly during the two years prior to the official launching of the euro.

(c) *The euro*

Despite some pain suffered by the member candidates in the run-up to monetary union, the euro was successfully launched – formally and technically – on 1 January 1999.²³ Member states obviously did not expect another dramatic change in Germany's economic conditions, but even before the formal start of the monetary union in 1999 Germany set off a deflationary race to the bottom. It de-coupled its cost level from the level of many other member countries by putting political

pressure on nominal and real wage growth. In fact, after 1996 the growth rates of unit labour cost fell consistently below the rates realized in Germany over many years before and below the pace consistent with the politically-agreed inflation target of close to 2 per cent. As nominal exchange rates were already fixed among the future members of the EMU, this meant a real depreciation for Germany.

From the narrow perspective of a German exporter, the strategy of wage disinflation has proved to be highly successful in boosting external competitiveness and net exports. Alas, the deflationary dynamics of German unit labour costs have pushed a number of EMU members into a very difficult position, experiencing a sharp and totally unexpected real appreciation. As a result,

Germany's current-account balance has improved from a deficit of \$27 billion in 1999 to a surplus of \$146 billion in 2006 – while its closest trading partners suffered corresponding movements into deficit. The irony is that, balancing domestic and external effects, Germany for a number of years has not really gained from its beggar-thy-neighbour policy. In large economies domestic demand is quantitatively more important than exports, and private consumption in Germany has stayed flat.²⁴ Meanwhile, the accumulated effects of improved competitiveness have dragged the economy out of stagnation. However, this policy of accumulating higher and higher surpluses and pushing other countries into a situation of permanently rising deficits is not sustainable and calls monetary coordination into question.

E. Lessons for monetary cooperation

1. *There is no alternative to regional cooperation*

The European experience with different forms of monetary cooperation, which eventually led to full-fledged monetary union, offers some important lessons for developing countries. Firstly, to avoid adverse implications for trade and to ensure the smooth functioning of a common market, there is no viable alternative to some form of managed fixing or managed floating of the exchange rate. This implies that some form of cooperation in monetary affairs at the regional level or even beyond is unavoidable. Secondly, designing monetary cooperation in a format that includes full monetary union as the final target is clearly superior to monetary cooperation without such a target. Systems based on anchoring one country to another are hardly sustainable in the long term.

An implication of the first lesson is that most political and academic discussion of the subject misses the relevant points. The much-used approach of judging the chances of closer monetary cooperation against free floating is based on the so-called optimum currency area (OCA) approach (Wyplosz, 2006), an approach trying to find certain criteria in trade or in factor mobility between countries to define those countries for which monetary cooperation including a fixing of the exchange rate is rational. An implication of the OCA approach is to assume that for all countries not fulfilling these criteria should just choose floating of their exchange rate vis-à-vis all trading partners. However, the European experience at several stages of the process leading to monetary union reveals the general weakness of this approach. In Europe, free-floating exchange rates have never been regarded as a viable alternative to monetary cooperation because of the perceived

trade distortions of a solution based on the “rationality” of financial markets. The fact that governments knew all along the way that there is no easy alternative to monetary cooperation prepared the ground for increasingly closer monetary cooperation. In developing countries as well, the simplistic alternative of leaving it all to the market does not exist. Hence this is one of the rare cases of a valid TINA principle: There Is No Alternative to monetary cooperation!

Floating provides formal autonomy to monetary policy as the central bank is free to abstain from intervention in the foreign-exchange markets. However, in the same way as formal freedom does not imply material freedom, formal autonomy does not imply material autonomy. The latter would be warranted only if the market determined exchange rates by strictly following the purchasing power parity (PPP) rule, i.e., the changes in exchange rates between two countries would always exactly equal the inflation differentials between these countries. With short-term speculation in the financial markets, however, PPP, is only valid over extremely long periods.

The lively recent debate on carry trades (short term trades carrying money from low interest rate countries to high interest rate countries irrespective of their inflation rates) and much other evidence (chapter I of this *Report*; and *TDR 2004*) points to the fact that short-term flows are mainly driven by interest rate differentials, bringing about exactly the opposite of the effect expected by PPP over the short- and medium-run. Countries with relatively high inflation rates and consistently high interest rates are swamped by short term funds driving up their currencies in real terms, destroying absolute and comparative advantages and distorting the production structure between tradable and non-tradable goods. If this happens, formal monetary autonomy becomes an empty shell.

Once this is acknowledged, much simpler arguments can gain ground politically. In Europe, the argument that fixed exchange rates and a unified currency would be necessary to complete the common European market predominated in convincing politicians to take the next step towards

monetary union. In fact, however, there was another powerful argument in the political debate that never found its way into the academic mainstream. Germany had convinced its neighbouring countries that the internal stability of the value of money, which means stability of the domestic price

level, has been the most important tool in Germany for reaching other targets of economic policy, namely, more employment and higher growth rates of real income. This meant that the argument that the external stability of the price level in a common market would be as important as its internal stabil-

ity could hardly be rejected any more. Obviously, the political will to adhere to the same economic policy and a similar monetary model as well as the target to loosen the ties of the international capital markets and of the United States policy helped to build consensus.

As mentioned above, however, agreement on the overall policy approach in an anchor system is not tantamount to an optimal solution for all member states. The anchor country’s policy, even if it were perfect under the circumstances prevailing in the anchor country, is not automatically the perfect policy for the whole group tied to that country even if there is consensus about the inflation target. This had been one of the main problems of the Bretton Woods system in the first two decades after the Second World War. Monetary policy in the United States, as conducted by the Federal Reserve System, would only take into account the economic environment in the United States when formulating its decisions despite the dollar being the anchor currency of the global exchange-rate system. Germany, as the anchor of the European Monetary System, acted in exactly the same way. For the system as a whole such a policy approach is not automatically adequate.

In this situation, the rigorously necessary policy option for the long term points to monetary union. In a true multilateral monetary system all countries participate fully in the decision-making process and the economic conditions of the whole area determine the conduct of monetary policy. Nothing short of a monetary union can help to avoid systemic mismanagement of monetary policy

The external stability of the price level in a common market is as important as its internal stability.

in any region unified in the belief that the internal and the external value of money should be as constant as possible. In Europe, the drive to create the EMU was not only justified by the French government's determination to avoid economic and political domination by Germany indefinitely, as many have argued. From an economic point of view it was a fully justified step as well, given the fact that Germany as anchor could not be synchronized with European needs in an overall non-inflationary environment.

For very small, extremely open economies that are closely linked to an anchor country, the anchor approach can be adopted for a relatively long time if, by and large, the anchor country's economic policy follows reasonable principles and takes into account the interests of the smaller partners. But for any larger group or for countries of equal size and/or economic power, the anchor approach can only be a transitional stage on the way to monetary union. A consistent monetary policy is only possible for the group as a whole and can thus only be realized by a unified central bank. Nevertheless, the transitional phase may last very long. From the first steps to the very last it took Europe 30 years to achieve monetary union.

On the positive side, the formation of the different steps towards anchoring and monetary cooperation provides participating countries with an enormous degree of independence from the rest of the world, including the international financial markets and international financial organizations. If the anchor is economically strong and stable, the regional group will be able to solve its external problems as a group and no single country will have to apply to the international financial institutions or the financial markets. This is the main argument for small, open developing countries to fix their currencies even unilaterally. However, compared with the advantages of the different pre-monetary union stages, unilateral anchoring methods such as currency boards or

dollarization are less than second best. These systems lack the specific advantages of the pre-monetary union stages without being sufficiently isolated from the floating rate regimes surrounding them (*TDR 2001*; see also Akyüz, 2002).

In general, for the governments of very open economies that have high esteem for the stability of the internal and the external value of their money, monetary cooperation is a useful device. This can take the form of either South-South or North-South cooperation depending on the strength of the trade ties between cooperating countries. If a coalition of willing partners is able to stabilize price levels without instituting a particularly restrictive monetary policy, strong arguments can be presented in favour of a nominal convergence for all countries that are trading with one another. Volatile short-term capital flows, arbitrage and frequent over- and under-valuation can be avoided,

with all their severe consequences on the efficient allocation of resources and on the dynamics of adjustment.

Regional cooperation among Southern countries or between countries at similar levels of development is preferable if one of the targets of this cooperation is a "competitive" exchange rate vis-à-vis big trading partners in the developed world. The evidence supporting the importance of such an approach regarding

the creation of pro-growth macroeconomic and monetary conditions is widespread (Rodrik, 2005; *TDR 2006*, chap. IV). The real exchange rate with respect to high overall competitiveness is an important component of overall monetary conditions. As long as the major developed countries refuse to accept a new global monetary arrangement along the lines of the Bretton Woods system, developing countries, particularly those bound together by openness and close trade ties, should strive for monetary arrangements that will guarantee a high degree of overall export competitiveness and sufficient external monetary stability at the same time.

Regional cooperation among Southern countries or between countries at similar levels of development is preferable if one of the targets of this cooperation is a "competitive" exchange rate vis-à-vis big trading partners in the developed world.

2. Regional macroeconomic policy is key for growth

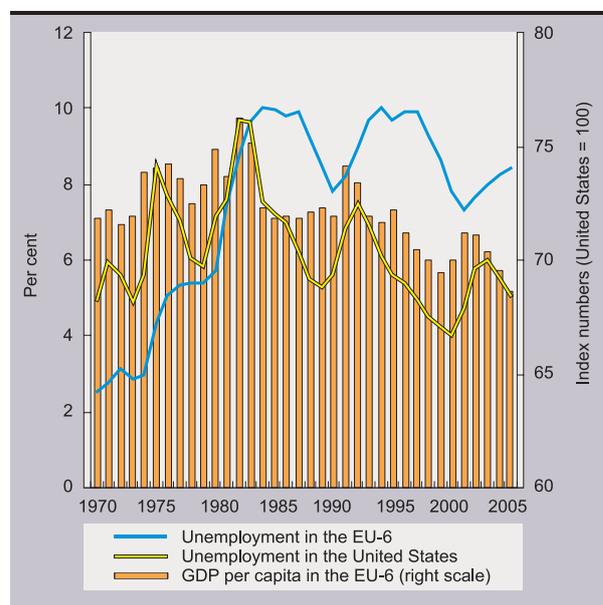
Given the success of European integration, the question remains as to why Europe did not succeed in its overall economic performance compared to the United States, especially since it de-coupled from the United States-led monetary arrangements of Bretton Woods. The economic performance of the six founding members of the EU has lagged behind that of the United States since the beginning of the 1970s. Surprisingly enough, the core countries of Europe were able to catch up impressively as long as they were members of a bigger global monetary arrangement led by the United States, the Bretton Woods system. After undocking from the big flagship they quickly lost ground in terms of GDP per capita and, even more important, in terms of unemployment (fig. 5.2)

Beyond data problems and a perceived preference for leisure in Europe, the search for reasons for this sudden drop has not yet provided convincing explanations. Based on the neoclassical conviction that long term growth cannot be influenced at all by short term economic policy, mainstream economic theory has mainly focused on so-called “fundamental structural changes” in Europe, like policy-induced inflexibility of the labour market or dramatic changes in the education system. The explanations of the lag in growth based on the preference for a voluntary increase in leisure in Europe explains only part of the observed divergence of per capita growth between core European countries and the United States (Blanchard and Wyplosz, 2004). The involuntary relative increase in leisure in the form of unemployment in Europe should not be ignored in such a comparison. There can be no doubt that since the middle of the 1970s the ability of Europe to contain the rise in unemployment by generating growth has been much less successful than in the United States.

This comes as a surprise to those observers who expected Europe, with its monetary anchor Germany, to make good use of the “monetary autonomy” that they gained after the demolition of the Bretton Woods system. Nevertheless, seen from another angle the main reasons for the failure to continue with a macroeconomic policy that

Figure 5.2

UNEMPLOYMENT RATES AND GDP PER CAPITA: EU-6 AND THE UNITED STATES, 1970–2005



Source: UNCTAD secretariat calculations, based on OECD, *OLISNET* database.

Note: EU-6: Belgium, France, Germany, Italy, Luxembourg and the Netherlands.

was successful overall are easy to understand. Firstly, most of Europe experienced a strong real appreciation of their currency and the concomitant loss of competitiveness in relation to the dollar area after the end of Bretton Woods. Secondly and more importantly, the anchor country’s central bank, the German Bundesbank, in searching for a new and stricter monetary paradigm, began an affair with monetarism. Unfortunately, this affair resulted in a long-term policy stance that was much more restrictive than that of the Federal Reserve System before and after the end of Bretton Woods.

In the EU-6, the overall growth rate and short-term policy interest rate have fundamentally changed their relationship since the middle of the 1970s. Whereas Germany and the United States featured similar and very expansive monetary policy stances during the 1960s due to the dominance of the Federal Reserve System, the situation changed radically thereafter. The policy interest rate in Germany has been higher than in the United

States most of the time since the end of Bretton Woods and also higher than the domestic growth rate. This points to a permanent cap of economic policy on the growth rate and a resulting inability of the economy to escape the unemployment trap. In the United States, on the other hand, monetary policy turned out to be much more restrictive for a short period at the beginning of the 1980s but returned to the traditional expansionary stance soon thereafter.

The important lesson for developing countries is that national economic reform agendas cannot be successful without an adequate macroeconomic policy. The reform agendas of the 1980s and 1990s concentrated almost exclusively on making countries more responsive to market forces in order to improve resource allocation. Improvements in the incentive structure in all markets were combined with discretionary state intervention that was reduced to a minimum. The results of this strategy among developing countries were mixed. Evidence provided by a range of studies in this regard suggests that a more proactive government that supports capital accumulation and productivity enhancement is needed for a smooth integration into the international division of labour and as a basis for sustained improvements in the welfare and income of all groups of the population.

For successful development efforts at the national level, the formulation and effective implementation of a national development strategy is of key importance, along with taking the right approach towards macroeconomic policies. In many cases in the past, attempts to get microeconomic prices right were countered and nullified by macroeconomic policies that got the macro prices wrong. In other cases, structural character-

istics of national economies or asymmetries in global governance rules discouraged a successful implementation of reforms. Additionally, as has been pointed out in the second generation reforms debate, the successful implementation of any kind of policy such as proactive trade and industrial policies requires a complementary set of institutional and administrative capacities.

The most successful cases of economic catching-up, namely those in Asia, never followed the simplistic recommendations of the “sound macro-policies approach” as preached in many circles despite price stabilization being a key target of their economic policy. Indeed, the assignment of poli-

cies to reach this target was just the opposite of the orthodox approach. In the Asian model of stabilization, monetary policy stimulated investment and growth whereas heterodox tools were used to control inflation. Government income policy or direct government intervention into the goods and the labour markets were the preferred instruments for stabilizing the price level. In an environment of breakneck growth, with the clear danger of ending up with

an overheated economy, this approach has passed its acid test.

The theoretical basis for these kinds of pragmatic policies is the perception that higher fixed investment is not the result of higher planned savings of private households but rather the result of economic policy action. This approach requires a monetary policy that provides cheap financing to entrepreneurs and enterprises so that they can realize investment in new production techniques or new products. Such policy, in the orthodox view, is inflationary and is clearly avoided in the prevailing “sound” approaches to macroeconomic policy (*TDR 2006*, chap. I, annex 2; and chap. IV).

For successful development efforts, the formulation and effective implementation of a national development strategy is of key importance, along with taking the right approach towards macroeconomic policies.

F. Conclusion

There is a growing recognition that global institutions by themselves are not able to promote developing-country interests. Thus, regional monetary and financial arrangements can offer the kind of sensitivity to and familiarity with local conditions – and not less important, the effective ownership – that are necessary for reconciling differing national needs and objectives with international opportunities and constraints. In particular, regional cooperation may provide decisive support for the management of exchange rates by the members of a regional bloc, without which further progress in trade integration would be very difficult. It may also expand the supply of long-term financing through the creation or reinforcement of regional financial institutions such as development banks and financial markets. Finally, it may reduce the vulnerability of the regional partners to the vagaries of the international financial markets by developing regional systems of payments and mutual financing, enforcing the use of national currencies and establishing regional mechanisms for policy coordination and macroeconomic surveillance.

At present, several developing countries have sought to reduce their financial vulnerability by accumulating large amounts of foreign reserves, thus creating a cushion of “self-defence” against external financial shocks. A regional approach – rather than one limited to the national level – may

be a more effective way of addressing these financial vulnerabilities. For instance, regional payment agreements that include clearing arrangements and the use of national currencies reduce the need for foreign “hard” currency and also diminish the cost of regional transactions. Furthermore, regional agreements on mutual credit and/or the pooling of part of the international reserves may also reduce the need for international reserves accumulation. To the extent that such credit and payment mechanisms, along with mutual insurance through regional agreements, reduce the amount that each country must keep in liquid foreign assets for transaction and precautionary reasons, financial resources are freed for more productive uses.

If an external financial shock affected simultaneously all members of a regional group of countries and did so with the same intensity, a regional financing agreement would be of little help. However, in general financial problems are localised initially and become a

regional or apparently “systemic” concern only after the problem spills over to other countries through a “contagion” process. If the initial difficulty is rapidly handled, not only would costs be minimised in the affected country, but also the contagion process might be avoided. Regional mechanisms are normally better equipped than multilateral institutions for rapid action since the member countries have a more effective ownership in its

Regional efforts to strengthen financial cooperation do not preempt multilateral efforts aimed at improving the international financial system and promoting its greater coherence with the international trading system.

governance and the disbursement of loans entails softer conditionality. In any case, given the size of the international capital markets there is no alternative to cooperation for small open economies.

In general, regional efforts to strengthen financial cooperation do not pre-empt multilateral efforts aimed at improving the international financial system and promoting its greater coherence with the international trading system. On the contrary, successful regional financial cooperation among developing countries may be one of the “building blocks” of an improved international monetary order. In fact, regional financing mechanisms may be either a substitute or a complement to international institutions. If the latter do not reform, regional agreements will be an alterna-

tive source of financial support even in the long run. But if international financial institutions change their orientation and governance structures in order to take into consideration better the needs and priorities of developing countries, then they could be the central office of a de-centralised monetary system in which regional funds would provide for the current financial needs of their constituents. The international institutions would thus function as a second-floor financing source, re-financing the regional institutions and acting as a lender of last resort in case of systemic crises. Eventually the organisation of regional monetary areas might become the cornerstone of a new international monetary system in which the hegemony of a key currency would be replaced by the principle of co-responsibility (Aglietta and Berrebi, 2007: 384). ■

Notes

- 1 This organization was founded in 1948. It was responsible not only for allotting the Marshall Plan aid but also for making sure that the conditions tied to it by the American Administration would be met: the reduction of trade barriers within Europe and the creation of a European multilateral clearing system for transnational payments. By 1955 its members were Austria, the Benelux countries, Denmark, France, West Germany, Greece, Iceland, Ireland, Italy, Norway, Portugal, Spain, Sweden, Switzerland, Turkey and the United Kingdom.
- 2 The Santo Domingo Agreements (1969) provided short-term financing to central banks facing transitory problems for complying with the multilateral clearing. Each country committed an amount of financing related to its IMF quota, plus voluntary contributions (the main contributors were Argentina, Brazil, Mexico and the Bolivarian Republic of Venezuela). In 1981 two new facilities were added, one for balance-of-payments problems and one for natural catastrophes, with longer repayment terms. However, in 1984, a multilateral decision suspended the Santo Domingo Agreements due to the simultaneous liquidity problems faced by all central banks members.
- 3 At present, the monetary authority of the Bolivarian Republic of Venezuela has decided that all imports originating from other LAIA countries must use the RCPA mechanism. This is a way to reinforce its exchange control regime.
- 4 Six countries (Brunei Darussalam, Indonesia, Malaysia, the Philippines, Singapore and Thailand) have each committed \$150 million; the remaining \$100 million is shared among Viet Nam (\$60 million), Myanmar (\$20 million), Cambodia (\$15 million) and the Lao People’s Democratic Republic (\$5 million) (Wang and Andersen 2002: 91).
- 5 Accessed at the website of the Ministry of Finance of Japan: www.mof.go.jp/english/if/as3_070505.pdf
- 6 At the meeting of the Ministers of Finance of Argentina, Bolivia, Brazil, Ecuador, Paraguay and the Bolivarian Republic of Venezuela in Quito in May

- 2007, the President of the host country called for the creation of a Fund of the South, which would pool part of the reserves of the participants. The Ministers agreed to postpone the discussion on the creation of that fund, and to strengthen the FLAR (*La Hora*, 3 May 2007, at: www.lahora.com.ec).
- 7 Long-term debt issued by FLAR was rated A+ by Standard & Poor's in early 2007, which compares with the ratings of Bolivia (B-), Colombia (BB+), Costa Rica (BB), Ecuador (CCC), Peru (BB+) and the Bolivarian Republic of Venezuela (BB-).
 - 8 Non-founding country members of CAF are: Argentina, Brazil, Chile, Costa Rica, Dominican Republic, Jamaica, Mexico, Panama, Paraguay, Spain, Trinidad and Tobago and Uruguay.
 - 9 ALBA (Alternativa Bolivariana para la América) is a regional integration initiative comprised of Bolivia, Cuba, Nicaragua and the Bolivarian Republic of Venezuela.
 - 10 See Kahn (2005) for a discussion of the merits of a regional bond market in sub-Saharan Africa and Bobba, Della Corte and Powell (2007) for the large effect of the creation of the Euro on the size of the Euro bond market.
 - 11 Botswana and Swaziland began to issue their own currencies, the pula and the lilangi, in 1974 and Lesotho issued the loti in 1980, while the Namibian dollar came into existence only in 1993 following that country's independence in 1990.
 - 12 The South African Exchange Control Regulations even state that "Namibia, Lesotho and Swaziland should be treated as part of the domestic territory and not as foreign" (*Orders and Rules under the Exchange Control Regulations* (1998), Section Instructions, as published in Government Notice R1112 of 1 December 1961 and amended up to Government Notice R. 791. *Government Gazette* No. 18970, 5 June 1998). See also Okeahalam, 2002. As a result of these structures, the banking sector in all CMA countries complies with international banking standards and regulations such as Basel I.
 - 13 Grandes (2003) provides an econometric estimate for the synchronicity of business cycles in Southern Africa. Jenkins and Thomas (1997) show a long-term convergence in GDP per capita over a 30-year period. However, neither of these studies takes into account the influence of labour migration and remittance flows.
 - 14 Although not part of official CMA policy, immigration to South Africa from other CMA countries is widely accepted. However, labour migration has led increasingly to social friction between residents and migrants, to which the South African Government has reacted by tightening immigration laws. For more details and background information on migration issues, see the website of the Cape Town based South African Migration Project (SAMP) at: www.queensu.ca/samp/. Founded in 1996, SAMP is an international network of organizations that aims at raising awareness of the migration-development link within Southern African countries.
 - 15 See *Traité modifié de l'Union Economique et Monétaire Ouest Africaine* (2003); *Traité instituant la Communauté Economique et Monétaire de l'Afrique Centrale* (1994); and *Traité de l'Union Economique et Monétaire Ouest Africaine* (1994).
 - 16 Formerly the minimum share of foreign-exchange reserves to be deposited in the *compte d'operation* with the French Treasury had been 65 per cent. For the BCEAO and the BEAC, the share was reduced in September 2005 and January 2007 respectively, whereas the requirement remained at 65 per cent for the Comoros (Comité de Convergence, 2007).
 - 17 For many agricultural products intervention prices had to be set on an annual basis in a common currency. Thus fluctuating exchange rates would provide opportunities for arbitrage, which would impair or benefit local producers in an arbitrary way. To deal with the problem of adjustments of the official exchange rates, a complicated system of "green parities" and compensating payments had to be installed.
 - 18 The United Kingdom and Denmark joined the snake soon after its introduction but left it soon after that. Norway and Sweden became associated members. Italy stepped out in 1972 and France withdrew its membership twice, in 1974 and 1976. When Sweden opted out in 1977, participants in the snake only included Germany, the three Benelux states and Norway.
 - 19 After September 1997 (Bâle-Nyborg-Agreement) this period was extended to two months and a half.
 - 20 Their population varied from 360,000 inhabitants (Luxembourg) to more than 60 million inhabitants (Germany). The per capita income of the poorest country (Ireland) was only 58 per cent that of the wealthiest country (Netherlands). Inflation rates ranged from 15 per cent in Italy to 4 per cent in Germany, unemployment rates ranged from 8 per cent in Italy to 3 per cent in Germany and trade-to-GDP ratios from more than 50 per cent for the three Benelux countries to only 18 per cent for France. Even intraregional trade strongly varied, between 31.5 per cent of GDP in Belgium to 7.6 per cent of GDP in France (Bofinger and Flassbeck, 2000).
 - 21 Krugman's description of the European crisis as the "second generation model" of financial crisis is at least misleading. Krugman (1998) is weighing heavily the fiscal situation of the countries in crisis but doesn't take into account how quickly they all turned around after the depreciation of their currencies despite high budget deficits. There have not been several generations of models but only variations on one theme, namely loss of competitiveness and rising current-account deficits.

- 22 During 1992–1993 the Nordic countries (Finland, Norway, and Sweden) abandoned their peg to the ECU and accepted strong devaluations of their currencies.
- 23 In 1997, membership criteria for participation in the European Economic and Monetary Union (EMU) as decided by the European Council and laid down in the Treaty of Maastricht (1993) became effective. To these criteria belong fiscal targets, e.g., a budget deficit less than 3 per cent of GDP and public debt less than 60 per cent of GDP. Although elevated to an oft-repeated truism by developing countries as well, these so-called convergence criteria are based more on political considerations than on an economic foundation.
- 24 Ahearne and Pisani-Ferry (2006) find that domestic demand in Germany has barely grown since 1999. See Flassbeck and Spiecker (2000) for a more detailed exposition of this argument.

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Annex 1 to chapter V

THE SOUTHERN AFRICAN DEVELOPMENT COMMUNITY

The Southern African Development Community (SADC) was founded in 1992 as the successor to the Southern African Development Coordination Conference (SADCC). It is comprised of 14 members: in addition to the five SACU countries, the other nine members are Angola, the Democratic Republic of the Congo, Madagascar, Malawi, Mauritius, Mozambique, the United Republic of Tanzania, Zambia and Zimbabwe. Regional integration is considered a means of alleviating poverty and redressing regional imbalances. With a trade protocol that came into effect in 2000 and a memorandum of understanding on macro-economic convergence, an ambitious programme for regional integration towards a customs union (2010), a common market (2015) and finally a monetary union (2018) have been initiated.

The Committee of Central Bank Governors of SADC, established in 1995, has initiated processes that should lead not only to greater macro-economic stability in the region and to the development of regional financial markets, but also to a more conducive environment for intra-regional trade flows. For example, considerable efforts have been made to harmonize national payments and clearing and settlement systems as well as to define a regional approach to cross-border payments (Committee of Central Bank Governors, 2006; SADC, 2006a; SADC Payment System Project, 2006). In August 2006, the Protocol on Finance and Investment was signed, which seeks to harmonize financial and investment policies. It aims at facilitating cross-border flows and prevent-

ing uncoordinated changes in investment policies by member countries in their efforts to attract FDI through fiscal and other incentives (SADC, 2006b). Effective implementation of the protocol would prevent a fiscal race to the bottom.

Furthermore, SADC is working towards full currency convertibility between member states to enable liberalization of capital and financial account transactions (SADC, 2006b: Annex 4, Articles 2–4). Regional coordination of the financial sector with regard to banking institutions, non-banking financial institutions, stock exchanges and development finance institutions is also envisaged. The 2006 Protocol establishes committees on tax, exchange control and payment settlement issues. However, it allows member countries considerable discretionary powers. For example, while the Protocol requires member states to accord equal treatment to intraregional and extraregional investors, it allows discrimination in the form of preferential treatment for certain investments and investors in order to achieve national development goals (SADC, 2006b, Annex 1, Articles 6 and 7). At this stage of regional integration, the strength of the Protocol is that it increases coherence in regional policies as it brings together finance- and investment-related issues that so far had only been discussed or developed separately.

Further regional integration in SADC is envisaged through setting a number of convergence criteria, including phased targets starting with a current-account deficit of 9 per cent of GDP and

Table 5.A1

**REAL EXCHANGE RATE VIS-À-VIS THE SOUTH AFRICAN RAND,
SELECTED SADC COUNTRIES, 1990–2006**

Country	1990 1995 2000 2005 2006 (Index numbers, 1990 = 100)					Average annual change		
						1990– 2000	2000– 2006	1990– 2006
						(Per cent)		
Malawi	100	170	125	180	187	2.1	11.1	2.4
Mozambique	100	180	111	143	136	-1.6	4.0	-0.5
Madagascar	100	123	85	111	105	-2.5	8.5	-1.7
Zimbabwe	100	127	96	249	..	-0.1	30.5	-1.0
United Rep. of Tanzania	100	110	58	96	99	-6.4	12.5	-2.3
Mauritius	100	97	74	96	97	-3.0	6.6	-1.5
Swaziland	100	102	97	93	92	-0.7	-1.3	-0.9
Botswana	100	100	85	85	86	-1.4	0.6	-1.8
Namibia	100	99	88	85	84	-1.1	-1.1	-1.3
Lesotho	100	94	87	83	82	-1.2	-1.5	-1.1
Zambia	100	113	79	66	48	-3.8	-4.6	-4.5

Source: UNCTAD secretariat calculations, based on IMF, *International Financial Statistics*, April 2007; and IMF, *World Economic Outlook* database.

Note: The real exchange rate is derived from the nominal exchange rate adjusted for relative changes in consumer prices. Calculations are based on period averages. An increase (decrease) means a depreciation (appreciation) of the national currency to the rand. For Zimbabwe, annual average changes refer to 2000–2005 and 1990–2005.

a budget deficit of 5 per cent of GDP by 2008, and becoming increasingly tighter thereafter (Bank of Namibia, 2006: 25). A degree of flexibility is provided for countries that fall victim to external shocks from international commodity markets or bad harvests. In recent years the commodity price boom and debt relief for Malawi, Mozambique, the United Republic of Tanzania and Zambia under the Heavily Indebted Poor Countries (HIPC) debt Initiative have eased budgetary constraints and assisted efforts at converging budget deficits and public debt targets. These could also help overcome reluctance to lower customs duties, a reluctance partly motivated by fiscal considerations, thus facilitating intraregional trade liberalization.

Another convergence target is achieving a GDP growth rate of 7 per cent per annum by 2008, reflecting an ambition to reach the first Millennium Development Goal (MDG) of halving poverty in parallel with faster integration. Since the beginning of the new millennium, GDP growth has acceler-

ated in most SADC countries, but this positive development is largely the result of favourable external factors, especially the commodity price boom, rather than the result of closer regional cooperation, effective integration or changes in national development policies. Indeed, the SADC agreement does not specify areas of cooperation that are directly aimed at accelerating growth or employment creation.

Since the turn of the century, GDP growth rates of SADC members have been on the rise and converging. However, there has been no discernible degree of GDP per capita convergence. The share of SACU in total SADC GDP in 2005 was the same as it had been 15 years earlier. Apart from Angola and Zimbabwe, which have exhibited severe monetary instability and fiscal disorder, a process of monetary convergence can be observed among SADC members, again led by SACU countries (Bank of Namibia, 2006; Banco de Moçambique, 2005; Bank of Mauritius, 2004). Since 2000, both

inflation rates and nominal short-term central bank interest rates have been converging towards a lower level. This should facilitate intraregional trade flows since intraregional exchange-rate volatility is reduced and this will increase the reliability of prices. In addition, real appreciations of bilateral exchange rates of SADC countries vis-à-vis the rand can be reduced. These appreciations have frequently distorted intraregional trade flows. Since 1990, 7 out of 11 SADC countries for which longer time-series data were available have experienced real exchange-rate appreciations vis-à-vis the rand. This has been the case particularly for the four smaller members of SACU (table 5.A1).

Three of these have pegged their currency to the rand, while Botswana has pursued a regime of managed floating with an implicit exchange-rate target vis-à-vis the rand. Since 2000 the real exchange rates of the smaller members of SACU have changed only slightly, while Mauritius and the United Republic of Tanzania have considerably reduced their real overvaluation, thereby increasing their competitiveness. However, fluctuations in SADC real exchange rates have been extremely high due to monetary destabilization in some countries such as Malawi, Zambia and Zimbabwe, and due as well to wider swings in the exchange rate of the rand vis-à-vis the dollar and the euro. ■

Annex 2 to chapter V

THE GULF COOPERATION COUNCIL

The unstable political situation in West Asia at the end of the 1970s led six countries of the Gulf region, i.e. Bahrain, Kuwait, Qatar, Saudi Arabia and United Arab Emirates to form the Gulf Cooperation Council (GCC) in 1981 (Heard-Bey, 2006: 199). Since its creation, the GCC has been following the standard economic integration steps: starting with a free trade area in 1983, it has established an effective customs union in 2003 and aims to implement a common market and a monetary union by the end of 2007 and 2010 respectively. Yemen, which had applied for GCC membership in 1996 and was accepted as an official candidate since 1999, joined GCC non-political bodies and agencies beginning in 2002 when Yemen and the GCC signed a protocol on their relations as an initial step towards membership. The main obstacle from the GCC countries' point of view is the different economic and political system of Yemen.

Membership in the monetary union does not strictly require the achievement of certain macro-economic criteria. However, GCC countries agreed that the convergence process has to be already started before the introduction of the common currency, the Gulf dinar (Rutledge, 2004). Therefore, in 2005 the GCC put into place a set of convergence criteria, similar to the Maastricht criteria of the European Union, which play the role of a barometer to gauge the readiness of member states for monetary union.¹

At present, all of the members have their currency pegged to the dollar, officially from 2003 and in practice for more than twenty years. The

only exception being Kuwait, who prior to 2003 had pegged its currency to a basket of foreign currencies dominated by the dollar and against which it had let its currency fluctuate in a band of ± 3.5 per cent (Sturm and Siegfried, 2005: 35–36). Thus, excluding renegotiations, current bilateral exchange rates define the entrance rates to the monetary union and the replacement of national currencies by the Gulf dinar. The already-practiced peg to the dollar implies that the official transfer of monetary policy to a common central bank appears to be less costly for the GCC member countries than for other countries that lack a nominal peg. Moreover, this cost should be lower because of the heavy dependence on oil and external shocks that could affect the GCC economies in a similar way. However, the creation of a GCC central bank to which monetary policy will be transferred, as well as its institutional set-up, has not been announced as yet.

With the exception of Oman, GCC member countries have been closely following the monetary policy of the United States Federal Reserve to determine their interest rates since 1995. Together with the fixing of exchange rates in 2003, both the level and variability of inflation rates within the GCC has been decreasing in the new millennium. Fiscal revenues have been boosted since the oil price increase and in 2004 all GCC member states realized considerable budget surpluses. Accordingly, in case of a sharp decline in energy prices, the Gulf countries expect to face higher fiscal deficits and debt-to-GDP ratios as already experienced during the 1980s. Some sug-

gestions were made to take non-oil revenues as a parameter for fiscal balances (Hanna, 2006). However, national demand for the non-oil sector is largely based on oil income; thus, the economic performance of the non-oil sector depends on the oil price and non-oil revenues are expected to fluctuate as strongly as oil revenues (Rutledge, 2004).

For GCC member states the risk of overvaluation due to a nominal peg to an international key currency is relatively limited. First, with the exception of the years 1991 and 1995, GCC countries had negative inflation differentials compared to the United States between 1980 and 2003, even though these differentials were diminishing. In the beginning of the 1980s the inflation rate in United States decelerated faster than in the GCC, and from the middle of the 1980s the inflation rate in GCC had been gradually rising before it surged from 2004 onwards due to the oil price hike. Second, since they are rentier states and major energy exporters for which price elasticity of demand is low, moderate real exchange rate appreciation does not

constitute a major problem in the short run. However, if GCC member States aim at improving their manufacturing sector and strengthening their non-oil trade links with the United States and Asia, even moderate real appreciation might counteract their efforts in the long run. Third, both labour and unit labour costs in the private sector are highly flexible in the GCC member countries due to their dependence on expatriates, who form a buffer that minimises the price effects of shocks and therefore limits overvaluation. This assumes that the liberalization of intraregional labour mobility will be extended to expatriates (Rutledge, 2004). In contrast, GCC nationals are still mainly employed within the public sector. Fourth, if the weakening of the dollar against the euro is to continue, the EU market could become an important target for the GCC non-oil exports, permitting a further diversification of GCC economies despite moderate real appreciation versus the dollar. In fact, the EU is already the largest importing partner of GCC countries, although the trade balance with the EU has been negative for the last twenty years. ■

Note

- 1 These criteria are: (i) a budget deficit under 3 per cent of GDP; (ii) public debt under 60 per cent of GDP; (iii) foreign-exchange reserves in excess of 4 months of imports; (iv) an interest rate not exceeding 2 per cent the average of the three coun-

tries with lowest inflation rates; and (v) an inflation rate not exceeding 2 per cent of the weighted average inflation of the total group. In 2006, Oman announced that it will join only at a later date (*Financial Times*, 12 December 2006).

REGIONAL COOPERATION IN TRADE LOGISTICS, ENERGY AND INDUSTRIAL POLICY

Economic integration, which brings with it an increasing division of labour and a dense network of linkages between firms within and across sectors and regions, is not simply the result of market forces, nor can it be “engineered” in an open society by State planning and intervention. This is true for integration at the national level as much as at the regional and international levels. Market dynamics, private-sector production and investment decisions, and attitudes of governments to different forms of economic cooperation with their neighbours all play a role; but regional integration processes are also conditioned by structural characteristics and the complementarity of the economies of a region, the compatibility of national economic policies, as well as the overall macroeconomic environment. This explains why formal regional cooperation in trade and finance can be associated with very different degrees of effective regional integration, and why such integration has sometimes occurred among countries without prior conclusion of formal trade arrangements or other far-reaching policy cooperation. Moreover, some areas of coordinated or common policy action at the regional level may be as important as trade liberalization, depending on the specific conditions in the different regions. This chapter discusses various examples of such policies, from developing and developed countries.

The quality of trade logistics and trade-related information flows has a direct bearing on regional trade dynamics, with possible attendant effects on structural change and growth. Section A discusses several issues in the area of trade logistics, including cross-border transport conditions, which are crucial for any exchange of goods to be physically possible. The subsequent sections examine areas of regional policy cooperation that focus more directly on sustained growth, diversification and industrial upgrading, and, by enhancing the trade potential, also feed back into the pattern of regional integration. Section B examines some recent trends in regional cooperation in the energy sector, which is beginning to be perceived in a new light, stemming from increasing environmental concerns relating to energy production and consumption, and growing apprehension about the adequacy of future global energy supplies. Finally, section C looks back at the history of integration in Western Europe and the lessons it could offer with regard to the possible role of regional industrial policies in support of development, notwithstanding the considerable differences between the conditions in Europe and those in developing countries.

While the quality of trade logistics is critical for regional trade to take off, regional energy and

industrial policies help raise productivity, diversification and structural change, which requires a long time horizon. For example, they may allow the financing and implementation of projects that would not be feasible for an individual country,

and could also avoid fallacy of composition. Successful cooperation in all these areas can support national efforts to strengthen internal integration in each country as well as successful integration into the global economy.

A. Trade logistics

1. *Regional trade and its transport: a virtuous circle*

Intraregional trade tends to grow faster than interregional trade, despite the fact that (unit) costs of international transport are declining. Over the past few decades, intra-Asian container traffic has been growing faster than global container traffic, just as intra-European or intra-MERCOSUR trade has been increasing at a higher rate than trade between these two regional blocs. For example, for containerized trade, intraregional traffic is forecast to overtake East-West traffic (i.e. between Asia, Europe and North America) by 2015 (fig. 6.1). Due to larger traded volumes and the resulting economies of scale, unit transport costs have declined and frequency and service quality have increased. Also, in many regions, more transport options (road and rail) are available. This reduces delivery times, allows more just-in-time delivery, and thus tends to increase the demand for goods and components. In other words, more trade leads to better and less expensive transport services, which in turn results in more intraregional trade.

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There is a potential two-way relationship between broader regional economic integration and integration in the area of transportation. Less expensive and better intraregional transport services lead to further regional economic integration, and at the same time regional economic integration often includes the liberalization of regional markets for transport services. Within the EU, for example, maritime cabotage services are mostly liberalized for European registered vessels, common standards help to create a common market for transport services, and trucks from different member countries are, in principle, and within certain limits, free to move national cargo in other member countries. Other examples of regional integration of markets for transport services include efforts by the Association of Caribbean States towards a regional agreement on air transport services, the Pacific Island Forum Air Services Agreement, the SADC Protocol on Transport, Communications and Meteorology, and the Andean Community's General Framework of Principles and Rules for Liberalizing Trade in Services. Such regional agreements can also be expected to promote FDI in transport, as this gives investors access to a larger market.

Regional approaches are also particularly appropriate for transport facilitation along main transport corridors, including waterways. For example, regional solutions are being sought along the rivers Paraguay-Parana in South America (Acuerdo de transporte fluvial por la hidrovía Paraguay-Paraná), the Nile (Nile Basin Initiative) and the Mekong (Mekong River Commission).

There are, however, exceptions to these general trends. Many African countries, for example, are still better connected to industrialized countries in other continents via air and maritime transport services than they are to neighbouring countries (UNCTAD, 2006a). Inadequate infrastructure and cumbersome border-crossing procedures are an obstacle to intraregional trade, and existing trade and travel patterns often make it necessary to travel to a neighbouring country via a European hub-airport. Intraregional trade will not benefit from integration initiatives at the political level if these are not supported by practical measures that facilitate the movement of goods within regions.

2. Trade facilitation as an instrument to promote regional trade

Information deficiencies are often believed to underlie many of the most important sources of market failure in practice. Therefore public support in the dissemination of information on market opportunities can be an effective instrument at the regional level for building business contacts among neighbouring countries. This may be of particular importance for the poorer countries with very thin markets and a low level of internal integration. In these cases, regionally organized trade support institutions that identify and disseminate relevant information on regional trade and investment opportunities, based on supply and demand surveys of specific products, could help enlarge markets and identify possibilities for production linkages across borders. Such services can be supported by the organization of trade fairs and regional buyers/sellers meetings to allow firms from neighbouring countries to promote their products and services within the context of existing regional trade agreements, thereby creating regional value chains for global competitiveness (ITC, 2006a).¹

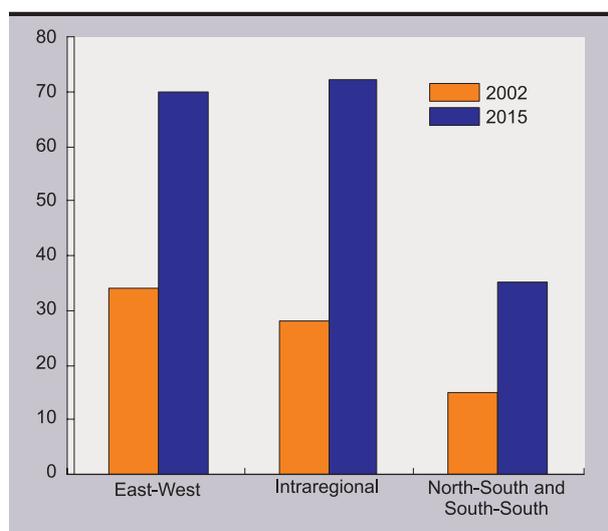
With these considerations in mind, an institutional network has been established in CEMAC and UEMOA, for example, for the management of trade information and the exchange of regional business opportunities among national trade support institutions to help small and medium-sized enterprises (SMEs) identify regional trade opportunities. A framework for trade information management and dissemination has also been defined for the Indian Ocean Commission (IOC) member countries to help them develop efficient national and regional information services and networks for the business sector (ITC, 2006b).²

In addition to information deficiencies, bureaucratic complications and inadequate transport conditions are frequently serious obstacles to the emergence of regional economic linkages. These problems cannot be solved by the reduction or elimination of tariff protection; rather, they require additional trade facilitation efforts. Many trade facilitation measures are achieved more easily at the regional than at the global level, including those that involve infrastructure, common standards,

Figure 6.1

INTRAREGIONAL AND INTERREGIONAL CONTAINERIZED MARITIME TRAFFIC

(Millions of TEUs)



Source: ESCAP, 2005: 32.

Note: TEU: twenty-foot equivalent unit.

Box 6.1**COMESA CUSTOMS DOCUMENT**

Article 69 of the COMESA Treaty provides for the simplification and harmonization of trade documents so as to facilitate trade in goods and services within the common market. It requires the reduction to a minimum of the number of trade documents and copies needed, and harmonization of the nature of the information to be contained in the trade documents. Article 71 of the Treaty further requires such trade documents to be designed and standardized in accordance with internationally accepted standards, practices and guidelines and to be adaptable for possible use in computer and other automatic programming systems. Accordingly, COMESA designed a single form for use as a customs declaration, the COMESA Customs Document (CD), which was adopted by the Council in 1997. To date 15 countries are using a Single Goods Document (SGD) based on the COMESA CD: Angola, Burundi, the Democratic Republic of the Congo, Egypt, Ethiopia, Kenya, Madagascar, Malawi, Mauritius, Namibia, Rwanda, Sudan, Uganda, Zambia and Zimbabwe. The remaining five countries (Comoros, Djibouti, Eritrea, Seychelles and Swaziland) are in the process of adopting an SGD. In addition, most COMESA member countries are using UNCTAD's ASYCUDA Customs automation system, which has also incorporated the COMESA CD.

Source: COMESA, at: www.comesa.int/trade/customs.

licences, trade documents (box 6.1) and even basic facilities such as opening hours at border crossings. Regional partnerships in trade and transport facilitation can play an increasingly important role in helping to reduce regional transportation costs by improving transport infrastructure, transit arrangements and trade facilitation at border crossings. Partnerships tend to reflect the multidisciplinary nature of trade and transport facilitation. They can support the sharing of good practices, the identification of bottlenecks that extend beyond a single country and the formulation of policy proposals that require parallel undertakings in several countries.

Regional facilitation partnerships can include a variety of players from the private and public sectors, non-governmental organizations and multilateral donors. Examples include the Trade and Transport Facilitation in Southeast Europe Programme, the Association of Southeast European PRO Committees, and the Transport Corridor Europe, Caucasus, Asia programme. Business organizations active in this area are mostly sector-

specific, such as the European Association for Freight Forwarding, Transport, Logistics and Customs Services, and the International Confederation of Customs Agents. In Latin America, private companies have formed the Business Alliance for Secure Commerce (BASC), which focuses on improving security along the supply chain, while at the same time aiming to facilitate legitimate trade (box 6.2).

Trade and transport facilitation across a region may follow different approaches, depending on the degree of economic integration and political cooperation. More heterogeneous regions may need special case-by-case approaches that focus on specific facilitation measures. Regions already having a preferential or free trade agreement or customs union tend to work towards introducing comprehensive, all-inclusive measures. The Economic Cooperation Organization (ECO), on the other hand, has directed efforts at trade and transport facilitation before moving towards trade liberalization. There may also be cooperation in this area between regional organizations, such as

Box 6.2**BASC: SECURITY STANDARDS AS A TRADE FACILITATION TOOL**

During the past 10 years, the Business Alliance for Secure Commerce (BASC) in Latin America has worked as an association between the private sector, customs administrations, governments and international organizations to promote trade and ensure its security. The Security and Control Management System (SCMS) developed by BASC aims to improve logistics and prevent terrorism and drug trafficking, which affect legitimate commerce. If such a management system were to be recognized by the different countries' customs authorities, operations could be expedited through simplified customs procedures and the dispatching of merchandise in an efficient and secure manner. This would save time and reduce costs, thereby benefiting traders. The BASC SCMS procedures require compliance with legal requirements. They define the security system and responsibilities, taking into account administrative skills and capacities, the need for ensuring security of facilities, information and goods, as well as the selection of suppliers and clients. BASC certified companies benefit from a solid reputation in international markets and have direct and permanent contact through their national chapters with customs authorities and international organizations that participate in the programme. At present, almost 1,800 companies in 13 countries in Latin America are benefiting from more secure commerce due to the recognition of the BASC SCMS by more than 20 customs administrations and international organizations.

Source: Business Alliance for Secure Commerce, at: www.wbasco.org.

between the EU and CARICOM and between ASEAN and the EU.

Land-based trade often requires transit through neighbouring countries. Many countries only allow goods to transit their territory if these are placed under customs surveillance during the transit operation and if a guarantee is provided. The guarantee ensures that in case the goods do not leave the territory of the transit country, either due to an irregularity or because they have been illegally introduced in the market of the transit country, the corresponding taxes and excises will be paid if evidence that this has not happened cannot be produced. Guarantee systems during the transit procedure are an alternative to actually paying duties and taxes on the goods. Guarantees are issued by the owner of the goods or an agent (e.g. a customs broker or carrier) for the benefit of the customs authority in the country of transit. International transit systems, such as the Transports Internationaux Routiers (TIR), rely on a mutually recognized guarantee and a single set of

documentation (e.g. the TIR Carnet, in the case of the TIR system). Although the TIR Convention is in principle international, it is mostly applied at the regional level in Europe and neighbouring Asia. China is considering becoming a signatory to the Convention, following the adherence of Kazakhstan and other neighbouring Central Asian countries. In some regions, regional solutions to transit systems are being sought, including in the COMESA region, West Africa, ASEAN and the Mekong region.

In South America, two regional agreements – in the Andean Community and in MERCOSUR – aim at facilitating multimodal transport (i.e. a trade transaction where goods are carried by at least two different modes of transport, but with a single transport contract). The multimodal transport operator must keep a contractual civil responsibility insurance policy that covers the risks of loss, deterioration, or delay in the delivery of the merchandise covered by the multimodal transport contract.

3. Distance, shipping and the geography of trade

Distance is usually assumed to be one of the main determinants of transport costs, and thus also of the trade competitiveness of countries. There is no doubt that distance has an important impact on the geography of trade. However, it is not distance per se that is a direct hindrance to trade; rather, it is transport costs and transport connectivity, which in turn are not only related to distance but also to the ease with which merchandise trade can be transported.

An UNCTAD study on the Caribbean subregion carried out in 2006, found that distance explains around 20 per cent of the variation in maritime freight rates, while competition among liner shipping companies and economies of scale have a stronger impact on the freight rate (fig. 6.2). For routes where there is no company to provide a direct service (i.e. where all containerized maritime trade involves at least one trans-shipment in a third country's port), freight rates per 20-ft. container averaged \$2,056 in the UNCTAD sample (UNCTAD, 2007: 14).

For routes where there are between one and four carriers providing direct services, the reported freight averaged \$1,449, and when there are five or more competing carriers providing direct services, the average freight rate was only \$973. Transit time and the quality of port infrastructure are additional factors that determine transport costs. This example suggests that strategic liberalization of regional transport services, through its impact on competition and economies of scale can have an important, and in some cases perhaps a decisive, impact on the establishment of regional trade connections and economic integration.

Another policy option to enhance efficiency of transport providers, and thereby reduce intra-regional transport costs, is to foster inter-port competition. In Europe, the intercontinental trade of many countries actually moves through the ports of neighbouring countries, whereas in most

developing countries, the handling of merchandise trade is typically restricted to the national port(s) of each country. However, there are a few exceptions, where ports also handle intercontinental cargo destined for, or originating from, neighbouring countries, thereby reducing land-transport distances and increasing competition among ports; for example, Mombassa (Kenya) and Dar es Salaam (United Republic of Tanzania) for East Africa, and Buenos Aires (Argentina), Montevideo (Uruguay) and Porto Alegre (Brazil) for MERCOSUR. In both these regions, ports also compete for intercontinental cargo of neighbouring, landlocked countries.

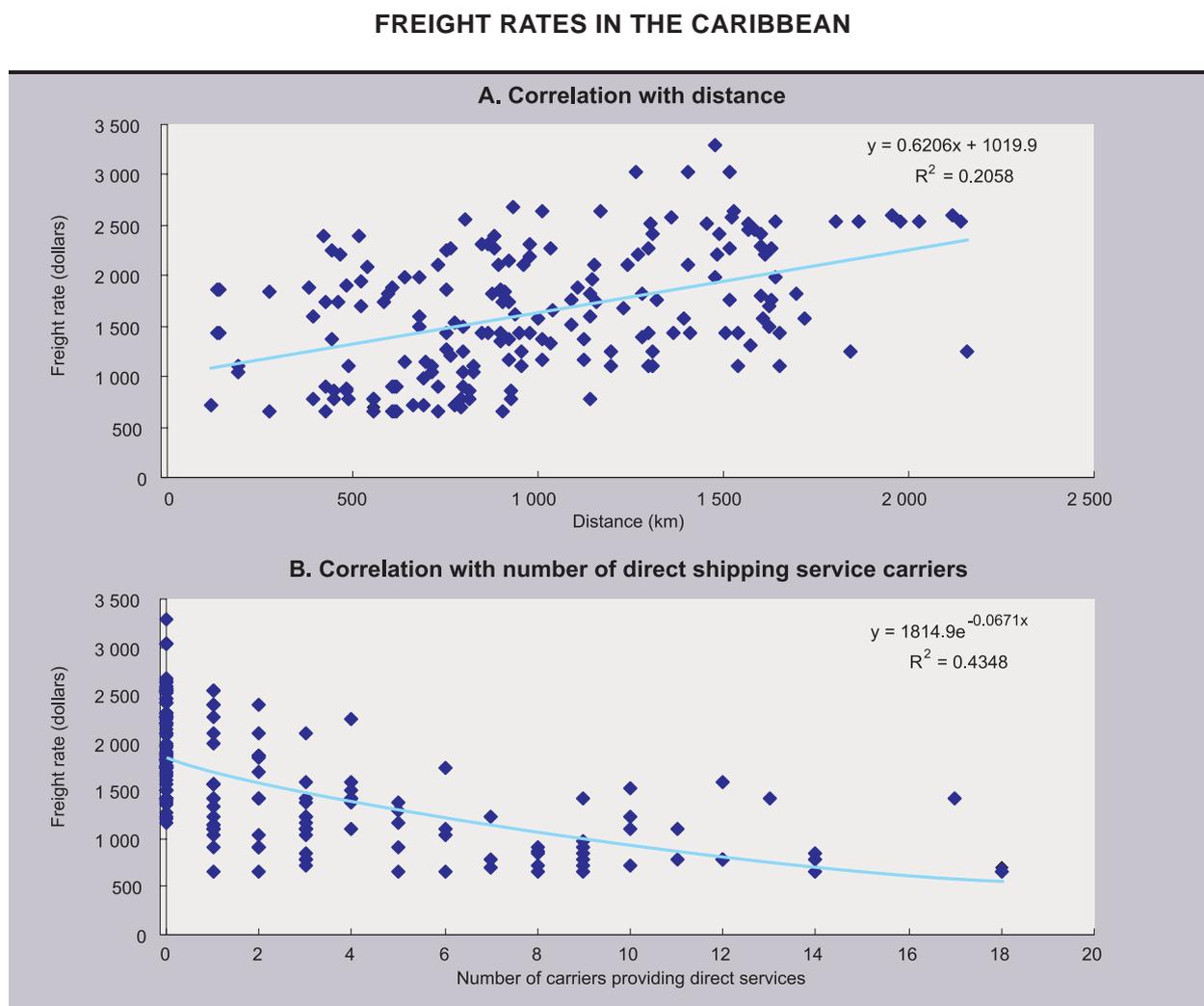
Enhancing inter-port competition requires corresponding road and rail infrastructure, as well as agreements on market access for land transport.

Another policy option to enhance regional competition in the area of transport is the integration of national (cabotage) and regional shipping services into global shipping networks. By allowing international carriers to also move cabotage cargo, or cargo between neighbouring countries, which at present might still be reserved for regional carriers, the overall market size would tend to increase, as well as the number of shipping options for national, regional and intercontinental cargo movements.

In some regions, developing countries trade much more with geographically close developed countries than with each other. While this is due in large part to the relative size of these economies and the structure of local production and trade, transport connections also play an important role. This is the case not only for Africa that trades mainly with Western Europe, but also for Central America and the Caribbean, where trade is concentrated in the United States and the shipping routes follow these trade patterns. Thus many specialized shipping lines connect the Central America and Caribbean island States with Miami, from where they receive most of their imports. Other shipping services link both regions to Europe and Asia via trans-shipment hubs in Jamaica and Panama. This combination of trans-shipment

It is not distance per se that is a direct hindrance to trade ... rather, it is transport costs and connectivity, which are related also to the ease with which merchandise trade can be transported.

Figure 6.2



Source: UNCTAD secretariat calculations.

Note: Data is for freight rates from an UNCTAD sample of July 2006, for a 20-foot container. Each point in the figure represents an origin-destination pair of countries in the wider Caribbean. Wider Caribbean covers all the islands in the Caribbean plus Central and South American countries bordering the Caribbean basin.

ports and shipping routes results in a situation where most of the little trade that takes place between Central America and the Caribbean islands is trans-shipped via Miami, Kingston or Panama, and through a few additional regional hubs such as Cartagena (Colombia) or Santo Domingo (Dominican Republic).

Although trans-shipment services imply additional port handling costs and longer journeys due to deviation distances, there is an increasing trend to use more of these services as it reduces

the overall network costs. Many services from Australia, New Zealand or the Pacific islands, for example, that used to be direct, now involve trans-shipment via Singapore. Similarly, the number of direct services between the west coast of South America and Europe has been reduced as direct services are being replaced with trans-shipment services via Panama and Jamaica. A large proportion of trade between South America and Asia is trans-shipped via Panama or via North American ports. Trans-shipment services have a potentially positive impact on South-South trade relations at

Box 6.3**REGIONAL TRANS-SHIPMENT CENTRES AND INTRAREGIONAL SHIPPING SERVICES**

The indirect benefit of trans-shipment services for intraregional trade can be illustrated by the simplified scenario that captures the effects of a recent reorganization in the shipping network pattern between Central and South America and other continents. In that scenario, Chile, Mexico, Venezuela and Panama traditionally had – mostly separate – direct services to Asia, North America and Europe. After reorganization by some carriers, direct services from Chile, Mexico and Venezuela to Asia, North America and Europe have been suppressed and replaced with indirect services via Panama. This means that each of the three services that used to go, for example once a week to Asia, North America and Europe, now only go as far as Panama. However, from Panama four services per week are now connecting to Asia, four to North America, and four to Europe. Clearly, Panama has gained from the reorganization, as have Chile, Mexico and Venezuela, as they are benefiting from better connections to the other continents. Although they now have fewer direct services, they gain in terms of the greater frequency of services via Panama, and they also have more options and choices among competing carriers. Moreover, the countries of the same region – Chile, Mexico, Venezuela and Panama – are much better connected to each other than before. Hence, the introduction of regional trans-shipment hubs is potentially beneficial to intraregional seaborne trade (for more detailed information, see UNCTAD, 2006b).

the regional level and beyond, because they enable the transport of relatively small volumes of merchandise trade, such as exports of Chilean wine to Cambodia and Cambodian exports of T-shirts to Chile, which would not justify direct shipping services.

Practically all coastal countries are connected to global shipping networks. Improved port operations, increased containerization, and changed shipping service patterns have enabled many coastal developing countries to engage in regular trade in manufactured goods with other coastal developing countries, which was not economically feasible two decades ago. There are 162 countries that are connected to at least one other country with a direct regular shipping service, and as a result of growing containerization and interconnection of lines in trans-shipment ports, there exist regular shipping services between all sea-linked countries of the world. UNCTAD research has shown that 17 per cent of the 13,041 pairs of sea-linked countries are connected to each other with at least one direct shipping service, while seaborne

trade between the remaining 83 per cent requires at least one trans-shipment (UNCTAD 2006b). Increased use of trans-shipment services can be particularly beneficial to South-South and intra-regional trade (box 6.3).

4. From landlocked to land-linked: potential gains from regional cooperation in trade and transport facilitation

Today, in view of greater global integration, high transport costs and low connectivity levels are more detrimental to a country's development than ever before, presenting particular challenges for landlocked developing countries. In the 1990s, these countries had a negative average per capita GDP growth (-0.9 per cent) compared to a positive growth (1.3 per cent) in transit developing countries (Chowdhury and Erdenebileg, 2006: 7). GDP per capita is around 43 per cent lower in landlocked developing countries than in their neigh-

bouring coastal countries. High transport costs and inadequate connections are among the key causes of this negative development.

Distance from the sea might appear to be a major factor. However, many capitals and actual or potential industrial centres of landlocked developing countries are no further away from the sea than many inland cities of coastal countries. Therefore the major difference is that landlocked countries face additional border crossings as well as possible obstacles to transport connectivity. The latter may be related to infrastructure quality and also to segmentation in the market for transport services.

Given the low trade volumes of many landlocked developing countries, there is an observed negative correlation between transport costs and trade volumes: low trade volumes lead to higher transport costs as a result of diseconomies of scale. This creates a vicious circle whereby low trade volumes of landlocked developing countries lead to high transport costs, which in turn discourage further trade.

Most landlocked developing countries depend heavily on the export of a few commodities and on official development assistance; as a consequence, they typically have a trade deficit in manufactured goods. This leads to high transport costs for imports, since freight rates also cover the transport of empty containers or trucks back to their origin. Moreover, delays and uncertainty of delivery times at border crossings are major obstacles to the export competitiveness of these countries. Most importantly, in today's globalized production processes, high transport costs and long delivery times for imports also lead to higher production costs of goods that are destined for export markets. High transport costs for imports also deter investment, especially in assembly-type industries.

In many cases, an important means of overcoming obstacles to trade competitiveness is the promotion of "corridors" and bilateral and regional transit arrangements between landlocked developing countries and their transit neighbours. Coastal countries have a greater interest in such regional

or bilateral arrangements for two main reasons. First, they have come to realize that efficient transit regimes may help their transport service providers and ports to generate additional business. Secondly, landlocked countries may themselves become important transit countries when coastal countries choose to trade by land with other countries in the region. Attracting business from neighbouring countries can reduce a coastal country's international transport costs due to economies of scale, and this can improve its own transport connectivity because the extra traffic volumes help to attract additional shipping services. It is not only well-established ports, such as Singapore or Antwerp (Belgium), that have managed to generate economic benefits from neighbouring countries' trade, but also African transit ports, such as Maputo (Mozambique) and Djibouti (Djibouti), which are providing significant business and employment opportunities for their local populations.

Today, high transport costs and low connectivity levels are more detrimental to a country's development than ever before.

In the context of regional integration processes, landlocked developing countries should aim at becoming "land-linked", rather than focusing on their landlockedness. Being land-linked implies that a country can help its neighbours to trade with each other by providing infrastructure,

transport and logistics services for trade transiting through it. Afghanistan, for example, is aiming at serving as a "hub" for trade between the Indian subcontinent and Central Asia; trade between the Russian Federation and China could benefit from transit through Mongolia; and the Lao People's Democratic Republic could become a transit country for trade between Thailand and China. Another aspect of being land-linked concerns the trade of the land-linked country itself. Where the landlocked country can increase its land-based trade with countries of the same region, rather than depending on seaports and maritime transport services, its trade costs might actually be lower than that of a sea-linked country. If, for example, Afghanistan could increase its trade with Central Asia or other neighbouring countries, it would reduce its dependence on trading through the ports of Karachi (Pakistan) and Bandar Abbas (Islamic Republic of Iran). In view of the economic growth of East Asia, the Lao People's Democratic Repub-

Box 6.4**TRADE FACILITATION AND TRANSPORT ISSUES IN THE CIS AND CENTRAL ASIA**

Trade logistics are of central importance not only in developing countries which seek greater integration with other countries in their region and with the world economy, but also for many transition economies, in particular in the CIS where many countries are land-locked and distances are very large, and where new trade patterns have emerged after the demise of the former Soviet Union. According to a World Bank report the situation is rendered even more difficult as some CIS countries have sporadically used their geographical advantage by unilaterally imposing temporary transit quota limitations and additional hurdles in customs clearance, such as mandatory high-cost customs conveying, insurance and other fees, often in contravention of existing customs agreements between them (Freinkman, Polyakov and Revenco, 2004: 50). The activities of the CIS Customs Committee, which aim at harmonizing customs documentation and procedures and also include the provision of training to customs personnel and technical assistance, have not yet yielded the expected results. Since bilateral mechanisms have not proved effective in solving customs problems, it has been suggested that introducing international disciplines through strengthened regional institutions might be a better means of upholding non-discriminatory transit and transport regulations and revitalizing existing multi-lateral agreements (Broadman, 2005: 45).

The countries that, since 2000, make up the Eurasian Economic Community^a (EvrAzES) – aimed at the creation of a common market – have started to implement an agreement to ensure unrestricted transit of the goods of member countries through their territories. This has the potential to bring a substantial increase in trade and welfare gains, given that several EvrAzES members rely entirely on overland transport for their exports. There appears to be considerable scope for further trade-facilitating cooperation among CIS members, and some of the most pressing issues are best – or can only be – dealt with by different forms of regional cooperation, such as harmonization of customs procedures, facilitation of international transport and transit, and strengthening energy supply and telecommunications networks (Freinkman, Polyakov and Revenco, 2004: 51; ECE, 2003: 181).

Trade and transport facilitation has been the main focus of regional cooperation in the Economic Cooperation Organization (ECO) long before a preferential trade agreement among its members was launched in 2003.^b These countries, which in their cooperation effort are reviving old historic ties, are all connected by land, and several of them are landlocked. Thus improvements in both land-based and multimodal transport facilities connecting the ports of the coastal countries with industrial centres in other parts of the region are crucial for the economic development of the entire region. The traditional trading links of the six CIS members had been either by rail towards the Russian Federation and onwards to Central, Eastern and Western Europe, or through several lesser used routes via the Caspian Sea, to the Caucasus Republics of Armenia, Azerbaijan and Georgia via the Islamic Republic of Iran or Turkey. But the evolution of global trade patterns over the past 15 years has influenced the trade and transport patterns of the ECO region, leading to the establishment of new rail links between the Central Asian Republics, China and the Islamic Republic of Iran, and the opening of a number of road border crossings between the Central Asian Republics and the Islamic Republic of Iran. The coastal countries can thus benefit from improved transit and transport connections to the Russian Federation and China.

^a Belarus, Kazakhstan, Kyrgyzstan, the Russian Federation, Tajikistan and Uzbekistan.

^b The organization was created in 1985 by the Islamic Republic of Iran, Pakistan and Turkey, and in 1992 it was enlarged to include six CIS members of Central Asia and the Caucasus (Azerbaijan, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan) and one other non-CIS member, Afghanistan. The six CIS members that joined ECO in 1992 are thereby reviving old historic ties. For more detailed information, see ECE, 2004.

lic and Mongolia might seek to increase their trade with, for example, China and Thailand. Such a strategy could also help diversify the structure of the landlocked country's foreign trade. Landlockedness in combination with changing patterns of trade is also an important policy issue in the transition economies, especially some countries of the CIS (box 6.4).

The mutual interests of landlocked developing countries and coastal transit countries appear to be greater than is often assumed, and regional cooperation in trade and transport facilitation may frequently lead to win-win situations, helping not only the landlocked countries, but also coastal countries to generate additional income and reduce their international transport costs.

B. Large regional projects: examples from the energy sector

Cooperation in energy and water supply is a central element in regional integration efforts among developing countries. Moreover, it is gaining in importance due to faster output growth in these countries at a time when global energy resources are becoming scarcer. Energy management requires not only measures to ensure that energy supplies are able to meet increasing demand, but also innovative policies to increase energy efficiency and support the exploration and use of alternative sources of energy. Considerable new investments in energy production and infrastructure development are necessary to meet this challenge. The large scale of such investments, their long pay-off periods and a mutual interest in securing energy supplies have provided an impetus for transnational and regional cooperation. Indeed, such cooperation was an important pillar of European integration in the 1950s, with the creation of the European Community for Coal and Steel and EURATOM (see section C).

The large scale of investments in the energy sector and their long pay-off period, as well as a mutual interest in securing energy supplies, have provided an impetus for regional cooperation.

In Africa, the importance of a well-developed regional energy infrastructure for industrial development, and thus for economic diversification and structural change, has been increasingly recognized. Regional cooperation in the area of energy also has the potential to leverage the necessary external support for financing the huge public investment needed to develop the energy infrastructure. The Economic Community of West African States (ECOWAS), where energy resources (petroleum and gas) are concentrated in coastal or offshore areas, initiated regional cooperation in power supply in 2000 with the launching of the West African Power Pool (WAPP) project. The project, to be implemented over a period of 20 years, aims at increasing and stabilizing regional energy supply and at improving the connections between national electricity grids. So far, ECOWAS has been able to obtain commitments of \$350 million from international organizations, donors and private investors. In addition, it plans to set up a fund to

finance access to energy services by remote regions and disadvantaged social groups, as part of the efforts to reduce poverty in line with the MDGs (USEIA, 2006).

Also in West Africa, Mali, Mauritania and Senegal are cooperating, through the Organization for the Development of the Senegal River, in the construction of a dam for the production of electricity and the creation of a related network for power transmission to the capitals of the three countries. Another example of such cooperation in Africa is

between the Gambia, Guinea, Guinea Bissau and Senegal through the Organization for the Development of the River Gambia. A common hydro-electric project is being prepared in combination with the regional integration of electric power grids in the four countries, which aims at ending the frequent power shortages and heavy dependence on imported petroleum products for the generation of electricity (USEIA, 2006).

A prominent example of successful regional cooperation with a bearing on both agricultural and industrial development, as well as on the achievement of the Millennium Development Goals (MDGs), is in water resource management in Southern Africa. In the Southern African Development Community (SADC) all continental SADC members share at least one transboundary river basin with other member countries; Mozambique alone shares nine such basins with its neighbours. There are also considerable imbalances between water availability and water consumption among its members; for example, South Africa alone accounts for more than 80 per cent of regional water consumption but has only 10 per cent of the region's water resources. SADC has made considerable progress in addressing these imbalances (AfDB, 2004), and it is the only regional cooperation scheme in Africa with a protocol on

Water resource management in Southern Africa is a prominent example of successful regional cooperation with a bearing on the achievement of the MDGs.

water issues that provides a framework for harmonizing national water laws and policies (ECA, 2004; ECA, 2006). Under its Regional Strategic Action Plan for Integrated Water Resources Development and Management, 31 regional projects are under way with considerable financial support from developed countries (AfDB, 2004; ECA, 2004).

In Asia, formal regional cooperation in the energy sector by the Association of South-east Asian Nations (ASEAN) has been more concrete and more far-reaching than in other

developing regions. In the mid-1980s, members concluded two agreements: an Agreement on Energy Cooperation and the ASEAN Petroleum Security Agreement. Coordination of national energy policies has helped strengthen not only the energy infrastructure of member States but also their position in negotiations and disputes on energy issues with other countries in the region (South Centre, 2007: 22). The ASEAN Centre for Energy (ACE), created in 1999, acts as a catalyst for growth and development in the member States by supporting joint activities for regional cooperation in the energy sector. It aims at coordinating energy strategies within ASEAN by providing relevant information and expertise on technological developments for energy efficiency and conservation. ACE oversees the ASEAN Plan of Action for Energy Cooperation that focuses on the creation of an ASEAN power grid and a trans-ASEAN gas pipeline to facilitate intra-regional trade in energy.³ These projects have the potential to improve efficiency in energy production and distribution at the regional level. The ASEAN power grid could enable the supply of cheaper electricity from members with better resource endowments and capacities for power generation

Coordination of national energy policies has helped strengthen the energy infrastructure of ASEAN and the position of its member States in negotiations on energy issues with other countries in the region.

to rapidly industrializing neighbouring countries with higher demand for power (Atchatawivan, 2006).

An innovative and forward-looking feature of ASEAN energy cooperation is the promotion of alternatives to conventional sources of energy, especially renewable sources, at the regional level. So far, little progress seems to have been made in this respect, but it is certainly an area of regional cooperation that holds considerable promise for the future, because, sooner or later, countries will inevitably have to engage in sustainable energy development. Moreover there is a huge potential in developing countries for the production of solar and wind energy and for energy from agricultural production owing to the favourable geographic and climatic conditions for such production in most developing regions.⁴ In terms of regional cooperation with a focus on new, and in particular renewable, sources of energy the EU is probably the most advanced. For example, it has recently launched an ambitious programme to support the production and use of alternative energies, including biofuels (see box 6.5).

Latin America has perhaps been the most active among the developing regions in pursuing regional solutions to the energy problem. These have included projects for electric power generation and the creation of cross-border and regional power grid interconnections, improved regional transport of gas through pipelines connecting several countries, agreements for joint exploitation of oil and gas resources, innovative financing schemes and preferential access to regional oil output.

An initial important step was the construction in the 1970s and 1980s of binational hydroelectric dams, by Brazil and Paraguay (Itaipu), Argentina and Uruguay (Salto Grande) and Argentina and Paraguay (Yacyreta) for joint generation of electricity. These joint projects also provided an electric power network among these countries that enables trade in electricity, particularly from Paraguay to Brazil and Argentina. These projects were the result of State-led initiatives, part of the pro-industry development strategies that were widespread in Latin America until the early 1980s.

Following orthodox policy reforms in the 1990s Latin American energy policies are again being reviewed in several countries, especially with regard to the role of the State in the production and distribution of energy.

Further initiatives to create power grids between different countries took place within regional agreements such as the Central American Common Market and the Andean Pact (now renamed the Andean Community of Nations).

Since the beginning of the 1980s, there has been cooperation in the provision of oil, including special financing arrangements, by the major Latin American oil exporters to those countries in the region that depend on oil imports. After the second oil-shock in 1979, Mexico and Venezuela agreed to supply up to 160,000 barrels per day to 11 Central American and Caribbean countries,⁵ with special financing arrangements covering 20–25 per cent of the oil bill. This agreement has been extended on an annual basis ever since. More recently, the Petroamerica initiative (box 6.6) sponsored by Venezuela has also adopted this form of regional cooperation.

A changing regional approach to energy production and management, as adopted in the Hemispheric Energy Initiative (HEI) with the participation of the United States, reflected the orthodox policy reforms of the 1990s.⁶ This initiative aimed at the privatization of public energy providers and extensive deregulation of the sector, including opening it up to private and foreign investors, liberalization of energy pricing and the provision of additional fiscal incentives for foreign investors.⁷ Since 2001, however, the HEI has lost much of its dynamism,⁸ and energy policies are being reviewed in several South American countries, especially with regard to the role of the State in the production and distribution of energy (Ruiz-Caro, 2006: 78).

The HEI, though not formally abandoned, has been replaced to a large extent by several South-South regional initiatives. The most comprehensive ones are the initiative for the Integration of the Regional Infrastructure in South America (IIRSA) of 2000, and the Plan Puebla Panama (PPP) of 2001. The latter involves the countries of the Central American isthmus⁹ and the southern states of Mexico. Both initiatives receive support from

Box 6.5

REGIONAL COOPERATION FOR THE ADVANCEMENT OF BIOFUELS IN THE EU

In Western Europe, regional cooperation in the energy sector has a long tradition dating back to the creation of the European Coal and Steel Community (ECSC) in 1952, which for over 40 years was an important tool of European industrial policy (see section C). In 2001, the European Commission launched an energy policy initiative to promote the use and production of biofuels for transport in order to reduce greenhouse gas emissions and the environmental impact of transport. This initiative combines objectives related to energy security, technological innovation and agricultural diversification. The programme follows a “regulated market-based approach,” whereby government intervention is intended to help achieve the desired market outcomes. Initial non-binding targets for the share of biofuels in total fuel consumption were set at 2 per cent, to be reached by December 2005, and 5.75 per cent, to be reached by December 2010, compared with 0.6 per cent in 2002. Fifty per cent of the total supply is to be produced in the EU.^a As the share actually achieved in 2005 was only 1.4 per cent, the European Commission (EC), in acknowledging that the biofuels target for 2010 was not likely to be reached, proposed establishing a binding target of 10 per cent of biofuels in vehicle fuels by 2020.^b

The EC has also developed legislation on privileged tax treatment for the consumption of energy from alternative sources,^c including biomass or waste, while a third element of the EC biofuel policy relates to fuel quality.^d On the supply side, the EC supports the production of biofuels with a special programme of assistance for energy crops grown on non-set-aside land, under which energy crops are eligible for a subsidy of 45 euros per hectare. Currently, locally produced biofuels are not cost-competitive in the EU, mainly due to high-priced local feedstocks. Despite the recent reform of the sugar sector, EU sugar prices are expected to remain substantially higher than those on the international market, which means that sugar will continue to be an expensive feedstock.^e EU-produced biodiesel breaks even at an oil price of around \$72/barrel, while EU-produced bioethanol becomes competitive when oil prices are around \$107/ barrel. Therefore, while biodiesel is already competitive with oil (though not necessarily with imported biodiesel), bioethanol is still far from it. Consequently, the competitiveness of EU-produced biofuels will depend on subsidies, and in the case of bioethanol on import tariffs as well. Possible diminishing production costs may, however, change the situation in the years to come.

^a Directive 2003/30/EC of the European Parliament and of the Council of 8 May 2003 on the promotion of the use of biofuels or other renewable fuels for transport (*Official Journal* L 123 of 17.05.2003: 42–46).

^b Communication from the Commission to the European Parliament and the Council: An Energy Policy for Europe, COM (2007) final, 10 January 2007.

^c Directive 2003/96/EC of 27 October 2003 restructuring the Community framework for the taxation of energy products and electricity (*Official Journal* L 283 of 31.10.2003: 51–70).

^d Council Directive 98/70/EC of 13 October 1998 relating to the quality of petrol and diesel fuels (*Official Journal* L 350 of 28.12.1998), as amended by Directive 2003/17/EC of 3 March 2003 (*Official Journal* L 76 of 22.3.2003).

^e In February 2006, the EC adopted a significant reform that will considerably reduce protection of its sugar sector. On the impact of this reform on the biofuels markets, see Schnepf, 2006.

Box 6.6**PETROAMERICA PROJECT**

The Petroamerica project launched by Venezuela, the main oil exporter in South America, comprises three initiatives: Petrocaribe, Petrosur and Petroandina.

The Petrocaribe Agreement,^a signed in July 2005 by the Heads of State of Antigua and Barbuda, Bahamas, Belize, Cuba, Dominica, the Dominican Republic, Grenada, Jamaica, Saint Vincent and the Grenadines, Saint Lucia, Saint Kitts and Nevis, Suriname and Venezuela, guarantees the supply of Venezuelan oil to the other signatories under special financial conditions. A variable share of the oil bill – increasing with the price per barrel – is to be financed on concessional terms by Venezuela, and it can be honoured partly by payment in goods and services. The agreement also seeks to reduce intermediation costs, thus favouring direct trade between State agencies.

The Petrosur initiative provides a framework for a set of bilateral agreements signed since 2005 by Venezuela with Argentina, Bolivia, Brazil, Paraguay and Uruguay. It aims to foster cooperation and joint ventures between public oil and natural gas enterprises of these countries for exploration, exploitation and distribution (with Argentina, Bolivia and Brazil), joint construction of a refinery (with Brazil) and two gas segregation plants (with Bolivia). Similar to Petrocaribe, the agreements also stipulate the provision of Venezuelan oil under favourable financial conditions, (including long-term financing at low interest rates for part of the oil bill) and allow barter arrangements.^b

The Petroandina initiative of July 2005 is intended to serve as a platform for strategic associations of public oil companies of the Andean Community countries. Although the proposal has received a less favourable reception than the other two initiatives of Petroamerica, it has been agreed to consider this Andean energy initiative within the context of South American integration and existing bilateral agreements.

^a The text of the agreement is accessible at: www.petroleumworldtt.com/storytt05071002.htm.

^b For further details, see Ruiz-Caro, 2006: 30–39; and the Petr6leos de Venezuela S.A. website at: www.pdvsa.com.

multilateral and regional development banks.¹⁰ The IIRSA has identified transport, energy and communications infrastructure for 10 “Axes of Integration and Development”,¹¹ and has defined 335 specific projects requiring a total investment of \$37.5 billion (IIRSA, 2006). In addition, the 12 South American countries¹² created the Energy Council of South America in April 2007 to develop a continental energy strategy, a plan of action and a South American Energy Treaty. Under the PPP, almost 100 projects, worth \$8 billion,

in the areas of energy, transport, communications and tourism were considered, and six of them were completed at the beginning of 2007.

Central American countries are implementing the SIEPAC project (a system for establishing electricity interconnections amongst them), which has two pillars: the physical regional interconnection of national power systems, and the creation of a common legal and regulatory framework to promote integration of the regional electricity mar-

ket. Progress made so far with the creation of a regional electricity network has included the exchange of electricity, reduced rationing and improved efficiency in the production of electricity (Ruiz-Caro, 2006: 60–62). Further development of the Central American electricity system could result in economies of scale in power generation.

In 2002, the Andean Community of Nations adopted a legal framework for harmonizing the policies and regulations relating to the electricity market, strengthening competition, preventing discriminatory practices and liberalizing trade in electricity.¹³ Power interconnections are already operational between Colombia and Ecuador, and Colombia and Venezuela, and will soon be established between Peru and Ecuador. Similarly, several grids link the electricity systems of the Southern Cone countries.¹⁴

There has also been significant investment in the construction of gas pipelines in South America, which has stimulated trade in gas among the countries of the region. In addition, several projects for further extension of the regional network of gas pipelines are either planned or under way.¹⁵ There is considerable potential in this area since some countries, in particular Bolivia and Venezuela, are able to exploit gas reserves in excess of their own needs, which could meet the rapidly growing demand for gas by others such as Argentina, Brazil and Chile. These projects could be integrated into the wider project of the Southern Gas Pipeline (Gran Gasoducto del Sur) to provide a long-term solution to the supply of energy in the region by connecting the gas reserves of Venezuela with major destinations in Argentina and Brazil. It could also serve Bolivia as a gas supplier, and Paraguay and Uruguay as consumers (Campodónico, 2007: 76; Ruiz-Caro, 2006: 44–45). Although this project is ex-

Regional energy cooperation can leverage the necessary external support for the huge public investment needed to develop the energy infrastructure.

Strengthening energy security through timely regional cooperation to identify and implement measures for energy conservation and the promotion of alternative sources could become a determining factor for long-term growth.

tremely ambitious and it is uncertain whether it can be realized as envisaged, its existence indicates a renewed interest in regional alternatives in energy policy. A case in point is Bolivia's decision to abandon a \$6 billion project to export gas to North America in favour of expanding its exports to neighbouring countries.¹⁶

In the context of regional energy cooperation in Latin America, the public sector is again assuming a more prominent role in the oil and natural gas sector. Many contracts

signed directly between governments or public firms are leading to joint ventures in this sector, to concessionary financing, and also to the creation of trade between the countries, since Venezuela has agreed to payment for its oil deliveries in the form of goods and services.¹⁷ A further deepening of economic integration linked to the oil and natural gas sector is intended by the partners of the Bolivarian Alternative for the Americas (ALBA) initiative, under which agreement was reached in April 2007 for joint ventures between the national energy companies firms of Bolivia, Cuba, Haiti, Nicaragua and Venezuela for projects in areas such as exploration and exploitation of oil and gas fields, construction or modernization of refineries and the construction of power plants.¹⁸

So far, questions related to energy efficiency and renewable sources of energy are not receiving top priority in most developing countries. However, the questions will be inevitable in the not too distant future. Therefore, the intention expressed in the ASEAN 2020 Vision to "promote cooperation in energy efficiency and conservation, as well as the development of new and renewable energy resources" (AMEM, 2004) merits heightened attention among developing country

policymakers more generally. Given the strong regional dimension of many energy projects and the substantial research and innovation efforts im-

plied, strengthening energy security through timely regional cooperation to identify and implement measures for the accelerated diversification of

energy sources and sustainable energy development could become a determining factor for long-term growth.

C. Regional industrial policy: issues and the European experience

Pursuing policies at the regional level that support the process of industrial development requires more than a simple extension of national industrial policies. Regional integration processes raise several issues for industrial policy that go beyond the well-known general controversies concerning the rationale and the preconditions for adopting efficient industrial policies (*TDR 2006*, chaps. V and VI). In particular, there are institutional issues related to consensus-building and policy coordination among nations that often adopt very different approaches towards economic policy. Additional challenges also surround the question of how best the relatively poorer nations among integrating countries can be helped to achieve economic catch-up without adversely affecting the economic activity and income levels of their relatively richer partners.

Except for cooperation in the energy sector, experience with formal regional cooperation in the area of industrial policy has been limited to Western Europe since the early 1950s. Developing countries have increasingly realized the relevance of different forms of industrial policy at the regional level, but few concrete steps appear to have been taken in this direction. In Africa, the new SACU agreement of 2002 calls for the development of a common industrial policy and for cooperation in agriculture and competition policy. In Asia, members of ASEAN have made various attempts to develop a common industrial policy, including the

adoption of agreements for establishing large-scale joint and complementary industrial projects. The grouping has also aimed at the creation of production and trade linkages between member States in an attempt to support national import substitution policies through regional cooperation.¹⁹ ASEAN Vision 2020 refers to a regional industrial policy – albeit in very general terms – as an instrument for the establishment of an ASEAN common market, in order to strengthen ASEAN's position in the global supply chain and increase its international market shares. However, no concrete measures have so far been identified (South Centre, 2007: 58).

The West European experience suggests that the need for certain forms of industrial policy, including harmonization of national industrial standards and competition policy, become necessary as the integration process advances. While most policy instruments for directly influencing the level and pattern of industrial investment, especially when they involve fiscal incentives, are easier to use at the national level, increasing coordination and harmonization of such policies will be necessary to prevent undesired distortions in economic activity across the member States. In addition, regional institutions can add new dimensions to industrial policy, as they could enable the design and implementation of projects that might exceed the resource capacities of a single country but that may become viable if several countries were to pool their resources.

Industrial policy in Europe can broadly be divided into four phases. The sequence of these phases illustrates how the changing targets and instruments of industrial policy have evolved with the regional group's position in the international division of labour and have helped determine the main actors involved in the implementation of that policy. The beginning of the first phase, which predates the creation of the European Economic Community (EEC) through the Treaty of Rome in 1957, came to an end in the mid-1970s, as Western Europe became well advanced in its rapid productivity catch-up with the United States. The second phase, during which industrial policy became more defensive, began in the mid-1970s and ended with the Single European Act of 1987. The third phase is associated with a reorientation of industrial policy through this Act and continued until EU enlargement in 2004, which marks the start of the fourth phase.

The European Coal and Steel Community (ECSC) and EURATOM were the first two European institutions that, apart from providing a basis for sectoral trade liberalization, provided a framework for industrial policy in a broad sense. The creation of the ECSC in 1952 between France, Germany, Italy and the Benelux States involved a limited transfer of sovereignty to a supranational body even before the inception of the EEC. It satisfied United States geopolitical interests to integrate Germany into the Western bloc on an equal footing with other Western European countries. It also responded to the interest of some of these countries in preventing excess capacity in the very capital-intensive coal and steel industries through its coordination of investment and marketing (Foreman-Peck and Federico, 1999: 44). The ECSC provided for the pooling of the coal and steel resources of the member States, which were key sectors in their productive structures. A High Authority, which could

Developing countries have increasingly realized the relevance of different forms of industrial policy at the regional level, but few concrete steps have been taken in this direction.

Regional institutions allow the design and implementation of projects that exceed the capacities of a single country but may be viable if several countries pool their resources.

take binding decisions by majority vote, controlled the production of these industries in all member States, investments in those industries, as well as mergers and agreements among companies; it also supervised national government subsidies to these industries.²⁰ Within this regulatory framework, intra-regional trade in coal, iron ore, scrap metal and steel was fully liberalized. Although this trade doubled in the four years after 1953, the main achievement of the ECSC was probably a political one, "considering the wrangling over these ... resources that had bedevilled international relations earlier" (Foreman-Peck and Federico, 1999: 439). Indeed, given that steel had played an important role in arms production during the Second World War, confidence-building through cooperation among European States, in order to prevent the emergence of new conflicts, was a key objective of the ECSC Treaty.

Two other early regional cooperation projects, which can be considered as marking the beginning of a European technology policy, were the European Organization for Nuclear Research (better known as CERN, derived from Conseil Européen pour la Recherche Nucléaire), established in 1954, and EURATOM in 1957. CERN was established by 12 countries as a laboratory for the study of high energy particle physics, and was intended as a purely scientific organization in a domain requiring complex and expensive experimental facilities which no single State could afford on its own. It soon became the centre of a science and technology network for its 20 European members as well as for the many non-European countries that also participate in its research activities. Over the years, the institution has been credited with fundamental discoveries and has proved its ability to foster international cooperation and cross-fertilization among the national scientific communities. It has made significant breakthroughs, including the World Wide Web, which,

although unplanned, has had a major economic impact.

The main objective of EURATOM, which in 1957 brought together the same six members as the ECSC some years before and the EEC that same year, was to foster the use of atomic energy to meet the expected energy needs for European industrial development. At the time, electrical energy from nuclear fission was seen as a cheap energy source for the future, and the nuclear industry required additional engineering capacity for that sector to evolve. Thus, EURATOM not only provided for a common market in nuclear material and equipment for peaceful use, but also for the pooling of regional experts' skills, as well as for cooperation in research and development (R&D) of nuclear energy, which was considered key to solving the members' future energy problems. Although EURATOM was an example of regional cooperation in areas of industrial development that exceeded the financial and scientific capacities of individual member States, its impact remained limited. This was mainly because of changing trends in the energy market and the growing awareness of the previously underestimated or neglected technological and safety risks and the possible environmental impacts. In recent years, it has focused mainly on regional initiatives for nuclear waste management and nuclear safety standards. Overall, the achievements of EURATOM in terms of advancing technological change have been limited, which may at least partly be attributed to insufficient consultation and links with industry and social actors (Stajano, 1999). However, it has contributed significantly to the management of radioactive waste and disposal, which has been a shared challenge for all EU countries. Moreover, the EURATOM Treaty is said to have put in place the provisions for the research programmes that were to follow later within the framework of the EEC.²¹

When the EEC was founded in 1957 by the same six members States, they had not only benefited from a period of confidence-building through institutions such as the ECSC, but were also able

to draw on that organization's experience in regional cooperation and institution-building. The Treaty establishing the ECSC (in force from July 1952 to July 2002) thus served as the foundation for the development of the EEC and paved the way for economic integration.

The Treaty of Rome did not explicitly mention industrial policy. However, it embraced the concept that the reciprocal opening up of markets and the resulting free movements of goods, services and production factors would help bring about industrial restructuring. The result of this approach was the de facto maintenance of industrial policies at the national level which aimed at accelerating productivity growth as quickly as possible. State-owned enterprises, often benefiting from preferential treatment in government procurement

and generous State aid, were the key elements of industrial policy strategy during this phase. They had been established in most Western European countries – either during the Second World War or in the subsequent reconstruction period – in a wave of nationalizations of substantial segments of industry, especially those with supposed natural monopoly characteristics (e.g. electricity, gas and coal), and

of key industrial sectors, including steel and automobile industries. State-owned enterprises were also leading actors in the newly emerging and strategically important high technology sectors, such as nuclear power, computers and aerospace.

Transnational ventures among State-owned enterprises began with the aerospace industry due to this sector's enormous fixed costs for product development, and the most obvious were those among neighbouring countries. The best-known example of such ventures is Airbus, a consortium of British, French, German and Spanish aerospace industries, formed in 1970. It is also an example of a common industrial policy that had positive effects in terms of technological advancement, industrial upgrading and employment creation. (Neven and Seabright, 1995: 57). However there were other individual examples (such as the Concorde aerospace project) that were commercial failures.

When founded in 1957 the EEC benefited from a period of confidence-building in the context of the ECSC, and was able to draw on its experience of regional cooperation and institution building.

Transnational ventures involving large national enterprises have generally faced significant challenges relating to securing agreement on product specifications, production location and cost control. Moreover, such common projects have often been seen as a means to strengthening domestic industrial capabilities, generally through linkages with other sectors and spillovers of know-how and technology. As a result, individual countries have tried to obtain from each programme an equivalent to what they had contributed, without giving due consideration to common interests and benefits. This has often caused duplication and unnecessarily high production costs (Foreman-Peck and Federico, 1999: 443).

The second phase of European industrial policy relates to the period between the mid-1970s, the end of the “golden age” marked by the strong growth momentum gained from post-war reconstruction, and the Single European Act of 1987. The overall industrial policy objective of this phase was defensive, aimed at stemming deindustrialization and a pervasive productivity slowdown. National considerations continued to play a key role. Regional industrial policy during this phase was meant to smoothen the adjustment pressures that were mainly reflected in emerging industrial overcapacity and rising unemployment related to the recession following the first oil crisis and to the ascent of East Asian economies in industries such as steel, shipbuilding, and textiles and clothing.

Industrial policy actions typically took two forms. Individual firms were granted State aid, which was compatible with EC regulations, to enable them to reorganize their activities and become more efficient by investing in new machinery. Groups of firms were allowed to form crisis cartels to guide reductions in overcapacity and partition market shares according to historical quotas. In these cases, public aid was sometimes granted for dismantling obsolete plants. These actions affecting industrial activity within the Community were combined with selective trade policy measures vis-à-vis third countries. Exam-

ples of such protective trade measures were bilateral trade limitation agreements through so-called “voluntary export restraints” with Japan, concerning the automobile industry, and the Multi-Fibre Arrangement, negotiated under GATT auspices in 1973, which imposed quotas on the quantities of textiles and apparel that could be traded. Given their focus on sunset industries and the lack of support to dynamic industries (such as financial services, computers, telecommunications and semiconductor equipment), into which Japan and the United States were moving very rapidly, these policies were often criticized for blocking structural change, that eventually would be unavoidable, and therefore leading to “eurosclerosis”.

The third phase is associated with deepening economic integration, and marks the return to a more offensive industrial policy that was conceived horizontally (i.e. not explicitly targeting specific sectors). The Single European Act, which revised the Treaty of Rome and came into force in 1987, outlined the transition from a customs union towards an economic and monetary union. This process implies the break-up of the nexus between national industries and nation States. Deepening regional economic integration has an inherent political dimension, because economic interests and relations, as well as the design and implementation of instruments to accelerate the process of industrial and corporate adjustment to an extended market, must be redefined in a context that exceeds the sphere of influence of individual governments.

The initial industrial restructuring strategy within this process was based on the belief that: (i) the creation of a wider “internal” market (by 1993) would ensure the free movement of goods, persons, services and capital, which would enhance efficiency through increased economies of scale, and that (ii) reduced customs formalities and common voluntary standards would increase the effectiveness of cross-border trade and provide an additional stimulus to economic efficiency. One of the results of this strategy was a Europe-wide wave of corporate mergers and acquisitions. Na-

While some projects of a common industrial policy were commercial failures, others, such as Airbus, had positive effects in terms of technological advancement, industrial upgrading and employment creation.

tional governments continued to grant State aid, albeit now directed towards subsidiaries of select transnational corporations (TNCs), particularly those involved in the production of computer chips or motor vehicles. This led to competition between countries in offering the most favourable conditions to TNCs.

As a result of this industrial strategy, joint competition policy moved to centre stage. Economic liberalization and integration is difficult to steer without coordinated competition policies, because individual countries may be tempted to adopt lax competition policies, allowing the emergence of monopolies on their national markets in order to gain a larger share of particular industries on the regional market. Common or coordinated competition policies are also required to regulate market power in order to prevent monopolistic tendencies from distorting the process of market integration.

It was soon recognized that trade liberalization might lead to improved allocative efficiency and short-term growth effects, but also that for making an economy more dynamic in the longer term a direct stimulus to investment and innovation would be needed. As a result, the initial industrial restructuring strategy gave way to a more proactive stance. The Maastricht Treaty of 1992, which established the European Union, called upon the member States to coordinate their industrial policies. More importantly, for the first time it granted powers for formulating industrial policy to a pan-European institution – the Commission of the European Communities, which is the executive body of the European Union. Industrial policies were outlined in an EC White Paper (EC, 1993), which asserted that improved competitiveness of the Union's industrial sectors was necessary to raise employment and bridge the productivity gap with the United States. This gap was once again widening after a successful catch-up phase between the early 1950s and the mid-1970s. The new perspective

European industrial policies in the 1970s were often criticized for blocking unavoidable structural change.

Coordinated competition policies to regulate market power are necessary to prevent distortion of market integration by monopolistic tendencies.

also implied a shift in approach towards sector-specific policies. But while previous sectoral policies had targeted existing industrial sectors of great strategic and employment importance, such as the automobile and aeronautics industries, they now addressed the design and implementation capacities of innovative industries which would be able to influence the development of other sectors. Thus, although in principle this approach advocated horizontal industrial policies, it, nonetheless, included a sector-specific component by singling out the biotechnology, information technology and audiovisual sectors.

However, the role of the EC in funding technology policy remained marginal. In the 1990s, 16 per cent of the R&D conducted in the EU member States, involved cross-border cooperation and 5 per cent was under direct control of the EC. Nevertheless, it appears that this expenditure was instrumental in defining an EU-wide technology and industrial policy. According to one observer, EC funding and the financial resources invested by European industry in cost-sharing technology programmes had a significant impact on the growth and competitiveness of European industry and on cohesion in the EU (Stajano, 1999).

The coordination of industrial policy activities at the pan-European level, which is concerned mainly with promoting research and the adoption of new technologies, requires a framework with detailed specifications for different areas of R&D. The so-called “Lisbon Strategy” formulated by the European Council in 2000 was intended to provide such a framework. It aimed at making the EU “the most dynamic and competitive knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion, and respect for the environment by 2010”.²² The Strategy was based on the belief that the EU suffered from a productivity deficit with respect to the United States mainly because of its

much lower participation in the information, technology and communications (ITC) revolution, which in turn was responsible for insufficient modernization of production and distribution techniques.

Apart from its concentration on the knowledge economy, the most innovative element of this third phase was the shift from a “top-down” approach favouring national champions (i.e. the approach followed during the first phase) towards a “bottom-up” approach through the adoption of the concept of “networking” for industrial innovation (Bianchi, 1998: 174–180). This concept emphasized the development of SMEs and the promotion of transnational networks of enterprises, sectoral groups, operative units and local institutions in order to achieve common goals. A major consequence of adopting this approach was that, to a large extent, it transferred the capacity to formulate and implement industrial policies from national governments to the supranational and local levels. A major advantage of this approach was that it took into account the perspectives of local entrepreneurs regarding business opportunities and investment constraints, as well as their expertise in judging the economic feasibility of undertaking innovative investments. On the other hand, this form of collaboration risked creating closed and defensive interest groups that would be detached from a single common reference framework to guide and control individual actions in the name of common objectives and principles. The Commission also risked losing itself in the bureaucratic management of individual programmes, while at the same time, the so-called “open method of coordination” implied that implementation of national measures required to reach a common target could not be enforced.

The current fourth phase of industrial policy in Europe is associated with the enlargement of the EU to 27 members. The fact that, in spite of some catching up through pre-accession support, income levels in the acceding countries are significantly below the Union’s average level, has increased the challenge of catching up to global technology leaders while at the same time being

able to create or maintain cohesion among the member States. The instruments of EC cohesion policy are the Structural and Cohesion Funds. As a

result of accession to the EU of 12 new members, in 2004 and 2007, economic and social disparities in the EU have grown, so that countries that formerly were net beneficiaries of these funds now have to assume a net financial burden. The challenge of EU-wide cohesion policies, which absorb more than 35 per cent of the total EU budget, appears to have di-

verted attention away from industrial policies, although the two are closely related. Of the total Cohesion Fund expenditures, 62 per cent are supposed to finance projects linked to the Lisbon agenda for growth and employment (EurActiv, 2007).

However, the horizontal approach to industrial policies implemented through the Lisbon Strategy has so far generated disappointing results, as observed in the mid-term review of the Lisbon Strategy, the so-called Kok Report (EC, 2004). While the Report did not suggest specific remedies, it confirmed the relevance of horizontal industrial policy at the EU level (EC, 2004: 39–43). Apart from recommending that member States should offer tax incentives at the national level “for newly founded small and medium-sized enterprises (SMEs) that invest in research”, it called for “public support for R&D at the EU and national levels ... particularly on key technologies that drive economic growth, both to strengthen the science base and to increase the leverage effect on R&D investment by the private sector.” It also suggested that “Europe’s science base should be strengthened by funding and coordinating long-term basic research ranked by scientific merit via the creation of a European Research Council. At the same time, member States and the Commission should look at ways in which public procurement could be used to provide a pioneer market for new research and innovation-intensive products and services. In addition, increased efforts should be mobilised at national and EU level by all concerned stakeholders to promote technological initiatives based on Europe-wide public-private partnerships” (EC, 2004: 21). In implementing the Lisbon Programme to strengthen its manufacturing indus-

The Lisbon Strategy stemmed from the belief that the productivity deficit of the EU was due to its much lower engagement in the ITC revolution.

try, the EC is following an integrated approach to policies and actions in support of research and innovation. Certain industrial policy challenges, such as major competition issues, regulation of the single market and social and economic cohesion, are to be addressed at the European level by focusing on promoting conditions for increased adaptability to changes in the world market of individual manufacturing sectors (EC, 2005).

European Space Policy, building on a Framework Agreement between the European Community and the European Space Agency, which also includes non-EU members, is also understood as a form of industrial policy, although it also has obvious military and defence aspects. In the space sector, as an institutionally driven strategic industry, “governments compensate for the market failure which would lead to underinvestment in new technologies” (EC, 2007: 4). This is an example of regional cooperation in an area at the frontier of technological research and development, where a collaborative approach can not only prevent contradictions and incoherence between uncoordinated national policies, but also lead to achievements that would not be possible by individual countries in isolation, given the magnitude of the investments involved. Moreover, regional cooperation in this area serves to advance the development of the European space industry in the most cost-effective manner, while at the same time ensuring independence from other actors in access to space (EC, 2007: 5). It is also an example of regional cooperation undertaken in favour of developing a strategic sector that has substantial repercussions on other areas of economic activity through its increasingly important role in collecting and distributing information and through numerous research and technological spillovers to other sectors.²³

Taken together, the four phases of industrial policy in the European integration process demonstrate the importance of institutions with a long-term perspective on investment. They also show that coordination and consensus-building in pur-

su-ing industrial policies at a pan-European level are a major challenge. Budgetary transfers, traditionally a preferred instrument of European industrial policy, have been able to influence industrial restructuring. However, this influence has fostered technological upgrading only when it has been based on a vision as to which would be the promising industrial sectors. Moreover, budgetary transfers will achieve little if they try to preserve industrial sectors that have lost their comparative advantage, and, in particular, when they are used in a pan-European context with insufficient coordination and a lack of consensus as to the objectives.

One achievement of European industrial policies may be that they have disciplined State aid (including the granting of tax breaks) and harmonized standards and regulations, thereby preventing a return to the beggar-thy-neighbour industrial policies of the 1930s (Foreman-Peck and Federico, 1999: 457). On the other hand, Europe’s industrial policies often supported sunset industries as opposed

to emerging dynamic sectors, such as telecommunications, transportation, energy and financial services that would have generated the greatest benefits in terms of productivity growth and technological catch-up. Also, generally, there has been a lack of political integration as a complement to economic integration, resulting in a persistent heterogeneity of national approaches. The lack of institutional reforms makes decision-making particularly difficult in a group of 27 countries with widely varying in-

come levels, and therefore different economic policy priorities.

The European experience offers a number of lessons for developing countries, not only as an example of regional cooperation that has included various elements other than trade liberalization and the reliance on market forces to strengthen regional integration. This was already the case prior to the creation of the EU, although industrial integration among the Western European countries was already well advanced even before enhanced regional cooperation found support from

A major consequence of the “networking” approach for industrial innovation is that it largely eliminates the capacity of national governments to formulate and implement industrial policies and transfers this capacity to the supra-national and local levels.

the United States and Marshall Plan aid became instrumental in regional institution-building and supporting the dynamics of industrial reconstruction. From the very beginning industrial policy was part of the regional policy agenda, and even today, at a much more advanced stage of industrial development, it is still an area of common policy-making with a twofold objective: to strengthen integration within the EU, including convergence between the more and the less advanced members;

and to strengthen the position of EU industry, particularly the technological leaders in different sectors, vis-à-vis the rest of the world. From that perspective, an agenda such as the Lisbon programme, despite its disappointing results so far and the hindrances to its implementation, could be of similar, if not greater relevance for regional cooperation in industrial policy among developing countries that are trailing behind the EU in industrial upgrading.

D. Conclusions

The experiences of some existing and new regional cooperation initiatives in the specific areas of trade logistics, energy and industrial policies discussed in this chapter highlight the role of such cooperation in enhancing trading conditions and strengthening the potential for creating and upgrading technological, productive and supply capacities. Without adequate attention given to improving trade logistics, a strong regional trade dynamic is unlikely to unfold. Energy and industrial policies are becoming more urgent in a world of increasingly scarce traditional energy resources, growing environmental concerns and greater challenges of global competition, especially in manufacturing. The concrete forms of such cooperation will have to be adapted to the specific needs, institutional capacity and culture of cooperation in each region. Joint efforts and common policies that complement those at the national level could strengthen the position of the members of a cooperation agreement in the international trading and financial sys-

tems to an extent that cannot be achieved by independent national efforts. Gains from greater coherence of industrial policies among countries in a region and from the possibility to pursue investment projects, including in science and technology, on a scale unachievable by any single country, could compensate to some extent for the loss of national policy space in a globalizing world economy.

Additional efforts to tackle practical problems of intraregional economic relations may be as important as further trade liberalization.

Regional cooperation in the areas of trade and transport facilitation, as well as energy and water supply, is indispensable for the identification of bottlenecks that extend beyond a single country, and for the formulation of proposals to deal with constraints that require parallel undertakings in several countries. Improving trade logistics and transport connectivity is an obvious element in any policy that aims at making better trading opportunities work for accelerating growth and structural change. In many cases, formal trade liberalization may not lead to the desired result because some fundamen-

tal elements of trade logistics might be neglected, or might be used deliberately as non-tariff trade barriers. In other cases, insufficient or complete lack of infrastructure might make trade physically difficult, if not impossible, quite independently of the trade regime. Therefore, rather than focusing regional cooperation exclusively on the legal aspects of trade policies, additional efforts to tackle these practical aspects of intraregional economic relations may be as important as further trade liberalization.

Information deficiencies are often believed to underlie many of the most important sources of market failure. In addition to reducing red tape in cross-border trade and improving overall transport conditions, the creation of new regional information networks and institutions and the strengthening of existing ones for the dissemination of information on market opportunities would also be an effective means to broadening and deepening business links within a region. This would also enhance cross-border regional integration, especially of small and medium-sized firms.

Regional trade facilitation projects can directly reduce the transport costs of intraregional trade and unleash a virtuous circle of increasing trade and economies of scale in the transport sector, and reducing transport costs, which in turn may further stimulate intraregional trade. Many developing countries are better connected to other continents than to neighbouring countries, and therefore cannot fully benefit from the potential gains of regional integration. Within a geographical region trade is often land-based, whereas long-distance trade is mostly seaborne or airborne. Similarly, trade facilitation at seaports and airports tends to be more beneficial for interregional trade than for intraregional trade. Therefore, when designing regional trade facilitation programmes, it is important to decide with whom trade should be facilitated as a first priority. Enhancing trade with partners outside a region would require an emphasis on measures such as pre-arrival customs clearance at seaports, port community portals or the use of standardized documentation, such as

the FAL forms of the International Maritime Organization. If the priority is regional integration, trade facilitation should give emphasis to measures such as joint border operations, mutual recognition of trade- and transport-related documents and licences within a region, common documents or automated customs formalities at border crossings.

While the optimization of trade logistics contributes to increasing both intra- and extra-regional trade, the other areas of regional cooperation addressed in this chapter are geared towards influencing structural change, technological progress and growth more directly. In low- and middle-income countries, faster growth and industrialization are associated with increasing energy needs. Thus an efficient energy infrastructure is a precondition for economic development in general, and for industrial development and diversification in particular. However, it is very capital-intensive, requiring large-scale investment which governments in developing countries often find

The energy sector can be a starting point for regional cooperation, which may subsequently extend into more far-reaching areas of policy coordination or common policy-making.

difficult to fund. Yet, mobilizing such financing through privatization may not always be compatible with long-term strategic considerations. Moreover, energy supply and distribution is largely determined by the natural resource endowments of each country and only in a few countries can it be optimally organized without cooperation with neighbouring countries. For both these reasons, the energy sector can be a starting point for regional cooperation, which may subsequently extend into other and more far-reaching areas of policy coordination or common policy-making, as shown by the European example. When undertaken among poorer countries, initiatives for regional cooperation in the areas of energy supply and distribution and transport infrastructure, may also serve to leverage external financial support.

Past experience with regional cooperation in the energy sector, and the large number of new initiatives in this area, indicate that there is already a considerable degree of awareness of these issues in developing countries, but also that it is time to translate this into decisive and coherent action at the national and regional levels. The evo-

lution of Latin American energy policy shows that reducing the role of the State in a strategic sector like energy provision and leaving its control to large foreign investors without appropriate regulations is unlikely to lead to optimal outcomes for development. The particular structural characteristics of this sector make it prone to market failures, and, owing to its importance for the functioning and expansion of almost all other sectors of economic activity, there is a risk of such market failures being amplified. The perception that both the State and regional cooperation have an important role to play in the energy sector is not new: it already formed the basis of regional institution building in post-war Western Europe. Strengthening forward-looking regional cooperation in the area of energy has the potential to support national policy efforts aimed at accelerating industrial output growth, especially at a time when environmental concerns relating to both energy production and consumption have become increasingly pressing.

Energy management in the new millennium is not only about ensuring that traditional energy supplies match increasing demand; it also has to do with innovative policies to increase energy efficiency and support the exploration and use of alternative sources of energy. The challenges in this regard are formidable: energy research and technological innovation require substantial outlays, the adjustment process will be long and uneven, and the possible energy sources are not equally distributed across countries. All these factors have been driving transnational and regional cooperation in the field of energy management over the past 50 years, and their importance is growing as industrial development and output growth progress at the same time as environmental concerns become more and more serious.

Regional coordination and major regional investment projects are also an issue in other sectors besides energy. They can also be motivated by the desire to avoid costly overcapacities in other industries or to meet the requirements for investments on a scale that exceeds the capacities

of an individual developing country. Such cooperation is not always easy to achieve because of perceived conflicting national interests, especially when it involves financial transfers to a supra-national institution. However, the long-term benefits may outweigh the seemingly high financial costs, in particular when such cooperation and investments have the potential, following a period of confidence-building, to extend into other mutually beneficial areas of development. The experience of Western Europe, from the founding of the ECSC in the early 1950s to the European Space Policy in the new millennium, could hold useful lessons, not least in terms of the pragmatism that has governed industrial policy in the EU.

Tight budgets and human resource constraints frequently hinder developing-country governments from increased spending on “horizontal” industrial policies, such as support for innovation and R&D activities, for which there is no strong domestic lobby. Moreover, such activities have a relatively long gestation period and require substantial investments in physical and human capital. Industrial policy instruments aimed at boosting capital accumulation in manufacturing are likely to vary, depending on whether they are national or regional. While fiscal incentives

By providing public goods, helping to correct market failures, regional cooperation can deepen effective regional integration and improve the chances of successful integration into the global economy.

for certain types of investment or R&D will typically remain an instrument in the national domain, financing of such investments may well be supported through regional initiatives, either by pooling scientific and financial resources or by funding through regional development banks. However, industrial policies concern more than intervention in favour of the industrial sector. Once countries have embarked upon a strategy of selective opening up, the benefits from an open trade regime can also be increased through the creation of an environment that encourages competition, thereby enhancing industrial productivity growth. And since markets for manufactures in individual smaller developing countries are often very limited, involving only a few actual or potential suppliers, an effective competition policy at the regional level that takes into account the specific market structures, may be an additional element of industrial policy.

Collective action in the areas examined in this chapter will generally be a complement to national policies, but its scope extends beyond simple consultation on and coordination of national policies; and with increasing experience regional instruments may gradually substitute national ones. By providing public goods in support of long-term development strategies, helping to correct market failures and reduce asymmetries in a regional com-

munity, regional cooperation can deepen effective regional integration, strengthen national integration in each economy, and also improve the chances of successful integration into the global economy. Moreover, confidence-building through regional cooperation in these areas can also prepare the ground for more far-reaching forms of cooperation, for example in the monetary and financial area. ■

Notes

- 1 Organizing such events has been an important feature of technical cooperation provided by the International Trade Centre of UNCTAD/WTO under its South-South Trade Promotion Programme. In 2006, 750 small and medium-sized enterprises (SMEs) and 416 business associations from around the globe explored business partnerships during 14 buyers/sellers meetings and matchmaking events. These events generated new business worth an estimated \$32.5 million. Under this Programme, SMEs were also given training on aid procurement procedures, trade information and quality management to prepare them for their meetings with potential trading partners.
- 2 One indication of the need for such information networks is the fact that African firms supply just 10 per cent of the \$3.6 billion spent in United Nations humanitarian aid provided to the continent although the regional supply potential for the procurement of humanitarian aid items is likely to be much bigger.
- 3 For more detailed information on the ASEAN Centre for Energy, the Plan of Action and its implementation, see: ASEANenergy.org at: www.aseanenergy.org/.
- 4 The issue of alternative energy uses in ASEAN is discussed in greater detail in Atchatawivan, 2006.
- 5 Barbados, Belize, Costa Rica, the Dominican Republic, El Salvador, Guatemala, Haiti, Honduras, Jamaica, Nicaragua and Panama.
- 6 HEI is an energy-related working group established on the occasion of the Summit of the Americas in 1994 at Miami, where 34 Heads of State launched the process to establish a proposed Free Trade Area of the Americas, from Alaska to Tierra del Fuego. The guidelines agreed upon at the HEI meetings included the promotion of policies to facilitate the development of infrastructure, such as cross-border connections, in order to integrate energy markets and facilitate trade in the energy sector (HEI, 2001: 13).
- 7 Privatization was seen “as a means of introducing greater efficiency in the energy sector as well as reducing budget deficits and raising needed investment. Countries are competing for available investment resources” (USEIA, 1999). However, not all countries opened up their energy sector to private capital to the same extent. While Argentina, Bolivia, El Salvador, Guatemala and Peru privatized most of their energy sectors, privatization was more limited in Brazil, Colombia, Mexico and Venezuela. More recently, Bolivia and Venezuela re-nationalized most of the assets in their energy sector that had been privatized in the 1990s.
- 8 No ministerial meeting of HEI has taken place since 2001.
- 9 Belize, Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua and Panama.
- 10 These include the Inter-American Development Bank (IDB), the Andean Development Corporation (CAF) and the Fondo Financiero para el Desarrollo de la Cuenca del Plata (FONPLATA). The PPP has also established a Commission for Promotion and

- Financing comprising representatives of the IDB, the Central American Bank for Economic Integration (BCIE), the Andean Development Corporation and the Official Credit Institute of Spain (ICO). (For further details, see BIC, 2007; and PPP, 2004.)
- 11 The axes are: (1) Andean Axis (covering areas of Bolivia, Colombia, Ecuador, Peru and Venezuela); (2) Southern Andean Axis (parts of Bolivia and Argentina and most of Chile); (3) Capricorn Axis (parts of Argentina, Brazil, Chile and Paraguay); (4) Amazonas Axis (parts of Brazil, Colombia, Ecuador and Peru); (5) Guayana Axis (northern Brazil, Guyana, Suriname and Venezuela); (6) Southern Axis (Argentina and Chile); (7) Hydro-way Parana-Paraguay (across Argentina, Bolivia, Brazil, Paraguay and Uruguay); (8) Central Inter-ocean Axis (Bolivia, Brazil, Chile, Paraguay and Peru); (9) Mercosur plus Chile Axis (Argentina, Brazil, Paraguay, Uruguay, plus Chile); and (10) Peru-Bolivia-Brazil Axis.
 - 12 Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Guyana, Paraguay, Peru, Uruguay, Suriname and Venezuela.
 - 13 See Comunidad Andina, Decisión 536, 19/12/2002, at: www.comunidadandina.org/normativa/dec/D536.htm.
 - 14 In addition to those linked to binational hydroelectric plants, a number of major interconnections operate between Argentina and Brazil, Argentina and Chile, Argentina and Paraguay, Argentina and Uruguay, Brazil and Paraguay, Brazil and Venezuela and Brazil and Uruguay (Sánchez Albavera, 2006).
 - 15 A pipeline between Colombia and western Venezuela is expected to become operational in August 2007, and a projected new pipeline between Bolivia and Argentina (on which construction is due to begin in October 2007) would considerably increase Bolivian gas exports. Another projected gas pipeline would connect Peru with northern Chile.
 - 16 Bolivia's decision was the outcome of a complex political process, triggered by strong public opposition to the North American gas deal, as both the price for the gas agreed with the North American importers and the royalties payable to the Bolivian Government were considered inadequate (*TDR 2005*: 115). The contracts with the foreign companies were reviewed and it was agreed to increase the royalties. In the new agreement, two main customers of Bolivian gas, Brazil and Argentina, agreed to pay a higher price (between \$4.2 and \$5 per million British thermal units (BTU), compared to less than \$1 proposed in the North American project). In addition, Argentina and Venezuela have proposed to install gas separation plants in Bolivia and provide technical assistance to that country in the domestic use of its gas.
 - 17 For example, an agreement was reached on the exchange of Venezuelan oil against Cuban medical services.
 - 18 For more detailed information on ALBA, see *Acuerdos de Integración*, at: www.alternativa bolivariana.org/modules.php?name=Content&pa=showpage&pid=230.
 - 19 Examples are the Basic Agreement on ASEAN Industrial Projects signed in Kuala Lumpur, Malaysia in March 1980 (see: www.aseansec.org/6373.htm); the ASEAN Industrial Complementation Scheme (1981); the ASEAN Industrial Joint Ventures Scheme (1983); and the Basic Agreement on the ASEAN Industrial Cooperation Scheme concluded in Singapore in April 1996 (see: www.aseansec.org/6385.htm).
 - 20 The High Authority consisted of nine independent members, two each from France and Germany, and one each from Italy and the Benelux States, plus one common nominee. They represented both the executive and the legislative branch of the ECSC. The High Authority was accountable only to the ECSC's Common Assembly of 144 members delegated by the national parliaments. However, the Assembly, the forerunner of the European Parliament, had no legislative power, except over the budget, and only very weak controlling powers. Attached to the High Authority was an Advisory Committee of 51 members: 17 each representing producers, tradesmen/consumers and labour unions, while an independent Court settled disputes over the interpretation and application of the ECSC Treaty; its decisions were binding on both the Community's institutions and the member States.
 - 21 See interview with Webster (Head of the Unit for Nuclear Fission and Radiation Protection within the European Commission's Research Directorate General) in *CORDIS*, 23 March 2007, at: cordis.europa.eu/fetch?CALLER=FP6_NEWS_EURATOM.
 - 22 European Parliament, Lisbon European Council 23 and 24 March 2000, Presidency Conclusions. Available at: www.europarl.europa.eu/summits/lis1_en.htm.
 - 23 See, for example, Jaffe, Fogarty and Banks (1997) on the spillovers of the United States space programme, and Iorio (2002) on the role of "intangible assets", such as those created in the space industry, on economic development.

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