Africa and the Global Economy:
Multilateral and Regional Approaches to Integration

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1. Introduction

African economies have suffered from lack of effective participation in the global economy. As a result, they have been left further behind as other developing regions have narrowed the gap between themselves and the developed world. Successful global participants have achieved higher than average rates of economic growth. This has permitted them to increase the economic well-being of their citizens and achieve dramatic reductions in the incidence of poverty. The challenge facing African countries is how to improve their development prospects through more effective performance in the global economy.

Effective participation in world markets is a multi-dimensional challenge, of which trade and industrial policies are a key element. As the coverage of this report indicates, the trade and industrial policy environment involves a wide variety of policies whose effects are felt both at national borders and behind them.

There are many tracks for pursuing trade policies aimed at effective global participation, the most important of which are the multilateral WTO processes, regional arrangements, and special bilateral or plurilateral preferential agreements. For each of these avenues, however, the key to success is *domestic* policies.

This chapter reviews the relationship between multilateral and regional approaches to global participation, with an emphasis on the links of both to the domestic policy environment.

2. Global Evidence

2.1 Openness and Growth

There is abundant evidence of the importance of openness for economic growth. A necessary condition to participate in and benefit from the opportunities available in the global environment is a policy framework that facilitates international trade and investment.

The UK Government's White Paper on International Development (Secretary of State 2000) provides a particularly useful and balanced view of the role market-opening and other developmental policies in the promotion of development. While recognizing the importance of a wide variety of governance, and human, physical and natural capital investment policies, it recognizes the central role of trade policies in harnessing the forces of globalization for the benefit of the poor.

> "Everywhere it is clear that openness is a necessary – though not sufficient – condition for national prosperity. No developed country is closed. The initially poor countries that have been most successful in catching up in recent decades – the newly industrialising east Asian countries and China – seized the opportunity offered by more open world markets to build strong export sectors and to attract inward

investment. This contributed, along with massive investment in education, to the largest reduction in abject poverty that the world has ever seen." (Secretary of State 2000, p.17)

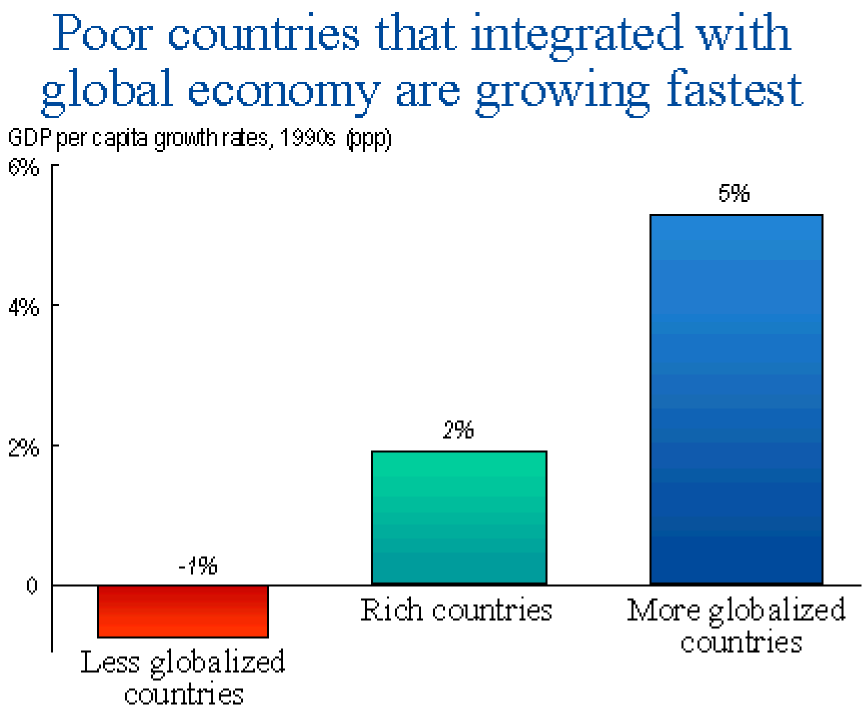
A number of recent studies have examined the empirical evidence in support of this view.

One of the most vexing questions facing such work is why, if globalization is so good for development, have so many countries, especially in Africa, fallen further behind during the final decades of the 20th century, during the height of the recent globalization experience? As we shall see, a large part of the answer lies in domestic policy choices in these countries.

A pioneering piece by Sachs and Warner (1995) demonstrated that trade policy strategies can explain a major part of the differences in economic performance among developing countries over the previous decades. In particular, their work suggested that for countries with relatively open trade policy regimes:

- economic growth rates were approximately 2 percent higher than in less open economies, and
- growth rates of poorer economies were greater than developed economies, suggesting that, for open economies, globalization has been contributing to convergence of incomes among rich and poor countries.

Figure 1



Source: The World Bank

Vigorous debate continues on the details of the relationship between trade and growth. However, not even the more serious critics of the Sachs and Warner findings dispute the central message. In fact, Dani Rodrik echoes the conclusions of the British government report of 2000: "No country has developed successfully by turning its back on international trade and long term capital flows" (Rodrik 2001). Fischer (2003) provides a useful review of some of the key issues here, including some summary charts on economic performance that highlight the low-growth performance of Sub-Saharan Africa.

There is little dispute about the necessity of economic growth for poverty reduction. Over the decade of the 1990s, fast-growing economies of East Asia saw the number of poor fall from 486 to 279 million, while slow-growing Sub-Saharan Africa witnessed an increase in the number of poor from 241 to 315 million.[1] Some other recent research (Dollar and Kraay 2000) has extended the work of Sachs and Warner to examine the effects of a variety of economic policies on economic growth, and in particular on the incomes of the poorest groups in each country. Their cross-country comparisons led them to conclude that

> "Income of the poor rises one-for-one with overall growth.…The effect of growth on the income of the poor is no different in poor countries than in rich ones….Policy-induced growth is as good for the poor as it is for the overall economy. Openness to international trade benefits the poor to the same extent that it benefits the whole economy.." (Dollar and Kraay 2000, p.1)

The evidence suggests that a large share of the blame for Africa's failure to benefit from globalization in recent decades rests on economic policies that have impeded effective participation in the world economy. Some of these policy failures – especially reluctance of developed economies to open key markets of interest to African producers – have been largely beyond the control of African policy makers.

But the evidence also points to the importance of domestic policies – insufficient opening of domestic markets to international opportunities and competition, and inadequate attention to complementary 'behind the border' policies, from infrastructure to regulatory regimes in key service industries, investment in education, maintenance of macroeconomic stability, and transparency of policy design and implementation.

2.2 Evidence on Gains from Trade Policy Reform

The potential gains from trade policy reform are difficult to estimate. This is due to both the wide range of policy measures that might be considered and the difficulties in modeling their complex effects.[2] The real benefit of such modeling exercises, however, is not so much to make precise predictions as to gain some perspective on the relative importance of different actions and of some of the major stakeholder interests that might be affected.

[1] See Table 1 of Fischer 2003, derived from data in World Bank 2003. Poverty is defined here as the number of people living on less than $1 per day.
[2] See Box 6.6 of World Bank 2002 (p.169), for instance, for a summary of the results of a number of attempts to quantify the benefits of post-Uruguay Round trade liberalization on industrial and developing economies.

Recent World Bank research (summarized in World Bank 2002, ch.6) illustrates the kinds of conclusions that arise from such work. The Bank modeled the effects of post-Uruguay Round trade liberalization scenarios in both goods and services. The principal conclusion is that further removal of barriers to world trade could raise global incomes considerably, by as much as $2.8 trillion. Over half of this increase would go to developing countries. This in turn would substantially reduce the global incidence of poverty. Liberalization of trade in goods alone could reduce the number of poor in the world by over 300 million persons. Over one-third of this reduction in poverty would occur in Sub-Saharan Africa. Trade reforms unleash the potential of the poor in developing countries.

The share of developing countries in the gains from reform is far out of proportion to their share in world incomes. This is especially true of Sub-Saharan Africa. This is because developing countries' trade and service policy environments are much more highly distorted than in industrial economies. Therefore, a large portion of the economic gains to developing countries actually could be obtained by unilateral trade liberalization by their own governments. However, rich country trade liberalization and deregulation of agriculture and textiles would also be of considerable importance to poor countries.

Another interesting finding is that the potential gains from reform in domestic services regimes in developing countries appear to be considerably greater than for liberalization of merchandise trade.

2.3 Summary of International Evidence

A trade- and investment-enabling policy environment is a necessary condition for achieving sustainable economic growth and poverty reduction. Of course, good trade policies are not sufficient. However, good trade policies tend to create an environment that focuses stakeholder attention on other areas where action is needed to remove barriers to development.

The focus of this report is on trade policies and in particular those that might help to promote regional integration in Africa. Regional economic integration, however, is not an end in itself, but rather is an instrument for increasing the degree and effectiveness of African economies' linkages with the global economy. The same is true of multilateral trade liberalization through the WTO. Through 'open regionalism' there is no doubt that regional integration can be a useful complement to other policies to integrate effectively in the global economy. However, regionalism on its own is certainly not sufficient. And there are some potentially serious pitfalls in regional approaches to international integration. As difficulties in the Doha Round of trade negotiations indicate, the WTO regime also suffers from serious weaknesses. Current WTO processes also provide some adverse incentives in the design of national trade policies.

It is with this in mind that this part of the report examines the role of regional and multilateral initiatives in global strategies for African economies.

3. Modes of and Opportunities for Global Integration

3.1 Multilateralism

The multilateral trading system as enshrined in the WTO provides a framework for a rules-based regime that applies to all members. While the WTO and its predecessor the GATT have made remarkable contributions to the removal of barriers to international trade, the task is far from complete. Industrial country protection of agriculture and of textiles and garments has biased the system against developing countries. Largely as a result of the high tariffs on garments and textiles, industrial country tariffs on manufactures from developing countries are several times the average levels of their tariffs on imports from other industrial countries. This is especially harmful to the interests of low- and semi-skilled workers in developing countries.

At the same time, continued protection in developing countries themselves has reduced opportunities for South-South trade and has had a crippling effect on industrial development possibilities in developing countries by raising the cost of access to imported raw materials and intermediate goods.

The Doha Round of WTO negotiations has been dubbed the ‘development round’, largely in anticipation of commitments of industrial countries to complete the unfinished business of the Uruguay Round in agriculture and textiles. The Agreement on Textiles and Clothing (ATC), the successor to the Multi-Fiber Agreement (MFA) is scheduled to expire in 2005. The hopes for significant progress in agriculture remain slim.

The WTO-based multilateral system provides two broad types of opportunities for improving the trade and investment policy environments of developing countries in Africa.

- It is an avenue for improving access to export markets, and

- it provides a commitment mechanism to secure and lock in politically sensitive or difficult trade policy reforms.

The WTO and Market Access

Africa certainly has much to gain from decreases in industrial country protection and improved market access, especially in certain key sectors. Under current mechanisms and negotiating processes, however, African countries have little bargaining power with which to influence the negotiations. Small market sizes in Africa mean that negotiators have very little to offer in exchange for market access concessions by industrial countries. This is not to deny that there are gains to be made through continued and more effective use of WTO negotiating processes, at the individual country level and through various types of collective action. There can be no doubt that the concerted actions of the ‘Group of 20’ (or G20+) played a critical role in the recent Cancun meetings.

A particular difficulty with collective negotiations for improved market access arises from the fact that some developing countries benefit from special arrangements that grant privileged access to highly protected industrial country markets. This is especially true in agriculture.

Quotas for sugar exports into the EU market, for instance, are of considerable value to a number of African economies. These quotas give access to the EU market at subsidized high prices, and removal of EU sugar subsidies would eliminate this benefit. By continuing to grant quotas to particular African countries, the EU reduces the external pressure for fundamental agricultural reforms by pitting vested interests in some countries against the greater general interests of the majority of African commodity producers that suffer from EU and other developed country agricultural policies. Participation in such quota schemes also encourages poor countries in Africa to engage in their own market-distorting agricultural policies. These policies protect the sugar interests that gain from EU access, but harm downstream processing industries with considerable development potential, and raise domestic prices of basic commodities that are important to poor consumers.

Similarly, MFA (now ATC) quotas on garments have become a scarce commodity, some of whose rents accrue to countries having access to them.

These kinds of arrangements give particular countries, or at least some stakeholders in these countries, a special interest in continuation of protectionist regimes that are detrimental to developing countries overall. The co-opting of certain interests in this manner creates conflicts of interest that make it more difficult to negotiate collectively in the WTO for more general improvements in market access.

Special bilateral and other preference schemes for particular developing countries or regions can create a similar vested interest for a continuation of industrial country protection. Extending preferences to larger groups of countries or reducing them through MFN tariff reductions simply erodes the preferences enjoyed under special arrangements for particular countries.

The WTO and Commitment to Reform

The multilateral WTO process can also serve as a useful mechanism for buying domestic interests that might otherwise block or try to roll back welfare-enhancing trade policy reforms. This is because of the need under this process to 'concede' domestic market opening commitments in order to obtain similar concessions in markets in which a country wishes to gain improved access for its own products. Under this system, domestic reforms and commitments are seen as the price that must be paid for market opening concessions by others.

"We cannot do this because it is contrary to our WTO commitments" is a frequently heard refrain in trade policy discussions in many countries. This suggests that the WTO might be an effective commitment mechanism, serving to restrain policy makers from supporting domestic vested interests through bad trade policies.

Against this, however, must be weighed several detrimental effects of the multilateral system as it currently operates.

First, the offer and request format of negotiations creates a perverse incentive for countries to delay implementation of self-interested trade policy reforms. Under this system, unilateral elimination of trade barriers deprives a country of concessions it otherwise would be able to offer in exchange for the acceptance of market access requests it might wish to make of other countries.

Much more serious, however, is the perpetuation of the 'mercantilist myth' that underlies WTO-style multilateral trade policy setting.

Lesson one about trade liberalization is that its principal beneficiaries are the citizens and residents of the country reducing its external trade barriers. For a small country, i.e. one too small to have a significant impact on world prices through its participation in international markets, the benefits of its own trade liberalization measures accrue entirely to itself.

Trade liberalization by any small country (and virtually all developing countries certainly fall in this category for the vast majority of their trade) has a negligible effect on world prices and hence on the trading possibilities of its trading partners. However, by bringing domestic prices closer in line with world costs and prices, it ensures a more productive and efficient use of its domestic resources, and lays the strongest possible foundation for long-term development. In addition, trade liberalization increases competition in domestic markets, and hence provides strong incentives to improve domestic productivity. It maximizes access of domestic producers to global supply networks of capital goods, raw materials and intermediate inputs, a critical condition for maintaining cost competitiveness and increasing productivity. These are major long-term dynamic benefits of trade liberalization.

These facts of economic life stand in sharp contrast to the standard myth of trade negotiation – i.e. that tariff reductions are concessions to one's trading partners. Perpetuation of this mercantilist myth is arguably a major cost of the multilateral trade liberalization exercises of the past several decades. The depiction of tariff reductions as concessions is a dangerous source of disinformation for policy makers and key stakeholders.

The language and the behavior of many negotiators seems to be based on the understanding that the benefits of trade liberalization by any country are enjoyed principally by other countries, and the 'costs' of granting market access are borne primarily by the liberalizing country. As a result, negotiators feel it is their job to resist making concessions that reduce barriers to imports in their own markets.

While an open and neutral trade policy regime is in the long term national interest, there are almost always some parties with a very large stake in protection against foreign competition. Furthermore, the special interest gains from (increases in) protection are generally highly concentrated, while its costs are often much more widely dispersed. Hence, the political pressures for (increases in) protection are often much stronger than those for liberalization.

Multilateral trade agreements can serve a very useful purpose in this context. They can be described as a means of securing preferential access to the partners' markets –

each member agrees to provide such access to its markets in exchange for reciprocal measures on the part of its partners. Trade liberalization can then be sold to domestic protectionist interests as a means of securing expanded market access for its own producers and sellers. Once entered into, such agreements then serve as a credible commitment to trade liberalization. The agreements can be a powerful tool, both to secure trade liberalization in the first place, and to resist domestic pressures for subsequent increases in protection.

However, there is a real danger that negotiators and the stakeholders in the participating countries have come to believe this protectionist rhetoric and conduct themselves accordingly. Negotiators in regional trade agreements, for instance, appear to be proud to have secured agreement on preferential tariff rates that exceed their WTO MFN commitments. Similarly, some Uruguay Round negotiators took similar pride in achieving WTO commitments to tariffs that were far in excess of rates actually been levied at the time.

Vested interests that gain from protection need no help in understanding how this happens. The danger, however, is that perpetuation of the myth of trade liberalization as a concession to foreigners gives exactly the wrong message to the true stakeholders in economic reform – policy makers and domestic citizens who will benefit from the domestic impacts of liberalization. The economic argument for free trade is apparently subtle and non-intuitive. The mercantilist myth of trade negotiations weakens the long term understanding of and support for welfare-enhancing trade reforms.

This is apparent in some discussions of Special and Differential Treatment (SDT) for developing countries in the multilateral trading system. In recognition of their special needs developing countries have been afforded differential treatment in two important respects, not only in the WTO framework, but also in a wide range of regional and other plurilateral and bilateral trading arrangements. This special status takes two different forms; provision of preferential access to industrial country markets and allowance for exceptions to and/or delays in implementation of WTO market-opening measures in their own countries.

Special and differential treatment reveals what is really a fundamental contradiction in the post World War II multilateral trade liberalization process. The special market access provisions in developed country markets reflect a failure of five decades of trade liberalization to open markets in many products (agricultural and labor intensive manufactures) of the greatest direct interest to developing countries. Special access through GSP and more recently through post Cotonou, EBA and the planned Economic Partnership Arrangements between the EU and the ACP countries are a poor substitute for fundamental reform by developed countries.

As observed earlier, selective (and quota-restricted) preferential access for agricultural products from selected developing countries creates divisions among the countries whose general interest would be best served by fundamental reform of agricultural regimes in developed country markets. Highly restrictive rules of origin that govern market access under preferential arrangements deny African countries the ability to source raw materials competitively in world markets, a practice that has been central to the success of East and Southeast Asia and of the few successful economies in

Africa and other parts of the world in recent decades (see Box 3 on Mauritius further below).[3] Safeguards and anti-dumping measures are other obstacles to rapid export growth from developing to developed countries.

What is seen as insufficient progress in MFN commitments by developed countries in areas such as these remains a key stumbling block facing the Doha development round, and was certainly a major reason for the failure at Cancun. SDT in the form of preferential access for developing countries in rich country markets is increasingly regarded as an inadequate response to the need for major reform.

At the same time, SDT provisions allowing developing countries more flexibility in engaging in the WTO processes reflect another fundamental problem – the continuing difficulties of many developing countries to participate effectively in the global economy.

Since the beginning of the GATT process, developing countries have been granted special exemption from or permission to delay implementation of a wide variety of market-opening measures, including removal of NTBs, binding of tariff offers, and elimination of high levels of protection for industrial development or revenue purposes. The Uruguay Round was the first time in which all agreements were embodied in a single undertaking signed by all members, developed and less developed. However, developing countries were given longer time periods to adjust to many new liberalization measures.

SDT provisions are founded on the recognition of developing country capacity constraints in multilateral participation. However, these provisions should not be used to promote an agenda that serves certain narrow interests and reduces the long term developmental gains from trade policies that promote the integration of developing countries in the global economy. African countries should not fall prey to the mercantilist myth of the GATT/WTO processes, regardless of the behavior of developed economies responding to their own domestic protectionist interests. Using SDT-sanctioned relaxation of liberalization requirements in this way would contradict the underlying developmental objectives of trade liberalization that is supposed to underlie the GATT/WTO processes.

The Uruguay Round negotiations saw some retreat from the near unanimity of developing country support for special and differential status. In the last quarter of the twentieth century, a significant number of developing countries pursued unilateral trade liberalization as a key part of their development strategies, and these tended to be the most successful performers among developing countries over that period. This experience had a salutary effect on negotiators in dealing with the special status and needs of developing countries. At the same time, there remains a great deal of unfinished business in liberalizing trade in developed country markets for goods of the most interest to many developing countries.[4]

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[3] See Brenton and Manchin 2002 for a discussion of possible effects of EU rules of origin.
[4] For further discussion of special and differential treatment in the WTO see Pangestu 2000 and Whalley 1999.

3.2 Regionalism

Regional preferential agreements are another mode for integrating countries more effectively with the global economy. These arrangements have been arguably the most rapidly proliferating form of trade diplomacy in recent decades and are now found in every corner of the globe. There are very few countries indeed that are not party to at least one and often several such agreements. The number and variety of regional trade arrangements in Africa are documented elsewhere in this report.

The recent profusion of regional trade agreements has provoked considerable discussion and some controversy, especially with regard to how they can be reconciled with the goals and principles of the multilateral trading system. Among the most obvious sources of contention is their clear violation of the principle of non-discrimination that has been one of the pillars of the GATT/WTO system since its birth. In light of this discrepancy with multilateralism, the question is sometimes phrased as whether regional trade deals are building blocks or stumbling blocks in developing the multilateral trading system.

The more fundamental question, however, is not a legalistic one about adherence to some abstract principle or to any WTO agreement, but rather an economic one about the effect of regional agreements on the growth of human development opportunities that can be facilitated by open trading regimes. From an African perspective, the question is how these agreements affect developing countries and especially the poor in these countries.

Another chapter in this report reviews many of the arguments related to the costs and benefits of regional trade agreements and there is no need to go over them in detail again here. However, it is important to recall that regionalism can encompass far more than trade. Indeed, these other dimensions – regional cooperation in infrastructure, services, trade facilitation and other areas – provide enormous potential for complementing and enhancing growth through trade at the unilateral, regional and multilateral levels.

In this section, however, we focus on some of the key questions that relate to the relationship between regionalism, multilateralism and the economic benefits that might be derived from market-opening trade reforms in Africa.

The benefits and costs of regional trade initiatives depend critically on how they are designed and implemented. The key issue is whether the agreements are designed with a view to promoting competitiveness in and integration with global markets or whether they are designed as ‘fortresses’ to insulate members from the international economy. ‘Open regionalism’ is the term that is often used to characterize the former approach.

Examination of a few particular issues helps to understand some of the potential pitfalls and problems with regionalism and how their resolution depends on the policy vision adopted in designing and implementing agreements. The goal is not to cast a pessimistic shadow over regionalism, but rather to shed light on how to make it most effective.

Trade Diversion

As explained in a previous chapter, preferential trade liberalization in regional trade arrangements has the potential to create new trade and welfare-enhancing specialization when high-cost domestic production in one country is replaced by lower cost imports from another member country that are made possible by tariff reductions on intra-regional trade. This is known as trade creation. On the other hand, increases in intra-regional trade that replace lower cost imports from non-members are an economically wasteful result of the regional agreement. This is known as trade diversion. A key determinant of the usefulness of regional approaches to international integration, therefore, is whether and by how much trade creation arising from trade preferences exceeds trade diversion.

Trade diversion arises solely as the result of tariff rate discrimination on the basis of the source of imports. Therefore, multilateral trade liberalization conducted under the WTO non-discrimination principle can never cause trade diversion. In this sense, multilateral trade liberalization is always superior to regional trade liberalization.

The extent of trade diversion that arises under any regional trade agreement depends on many things. One of the most important factors, and certainly the one that is most amenable to action by policy makers, is the relationship between preferential and non-preferential import tariffs.

Under the fortress view, high external tariffs are a necessary feature of a regional trade agreement. High external tariffs together with low or nonexistent intra-regional tariffs are the combination needed to foster regional development, free from the threat of external competition. This is also the recipe for maximizing the likelihood and amount of costly trade diversion.

Under the open regionalism approach, regional preference schemes are seen as part of a more general strategy to integrate with the global economy. Regional liberalization is meant to support and be part of processes promoting more general trade and industrial policy reform and hence should be coordinated to move in parallel with non-discriminatory trade liberalization. Successful implementation of this open regionalism approach minimizes the scope for trade diversion.

Costly trade diversion is an inherent danger of regional integration schemes. However, the magnitude of this danger and its associated economic costs for any member of a regional preference arrangement depends on the strategy it adopts with respect to the link between global and regional integration. Open regionalism, where regional liberalization is part of a more general strategy of non-discriminatory trade reform, minimizes the dangers and costs of trade diversion.

Rules of Origin

Rules of origin are required in any regional trading arrangement in order to authenticate that goods claiming tariff preferences result from significant economic activity in an eligible country. The rules are a means of preventing ‘trade deflection’ – importing products from outside the region into a member country with a relatively low external tariff and re-exporting them under regional tariff preferences into another member with a higher external tariff on the goods. The need for rules of origin for this purpose obviously depends on the height and intra-member variance of members' external tariffs. The greater they are, the greater will be the danger of trade deflection. Preferential rules of origin are clearly unnecessary in non-discriminatory trade policy regimes.

Rules of origin required for this purpose can be simple, transparent and need not impose serious constraints on producer behaviour in the region. The rules of origin adopted by COMESA are a good example in this regard.

However, rules of origin are often employed for far more than authentication. Under a less open approach to regional integration, rules of origin can and often are used as powerful instruments of protection. They can be designed to encourage certain regional activities or to protect them from potential competition arising from trade liberalization. This protection can be of two forms – preventing the emergence of regional competition as a result of regional trade liberalization, and encouraging regional production of intermediate or primary products.

Restrictive rules of origin deprive producers of access to raw materials or intermediate products from low cost international sources and hence raise their cost of producing for sale under regional preferences. This reduces or even eliminates their ability to take advantage of regional preferences; it shields existing producers from new regional competition, and deprives consumers from potential benefits of regional tariff reductions.

It can be argued that strict rules of origin might encourage the use of regional raw materials, thus giving support to the regional producers of such goods. Of course, such an incentive is necessary only to the extent that the local/regional costs of these materials are higher than international prices of the same goods. Therefore, the burden of such policies is borne in the form of higher costs by downstream user industries, making them less competitive internationally and forcing them to charge higher prices domestically. This is a self-defeating strategy since it reduces rather than increases the global competitiveness of regional producers and deprives consumers of the benefits of trade liberalization.

This use of rules of origin as a development tool is very similar to oft-failed import substitution regimes based on high levels of protection, local content rules and other *dirigiste* trade instruments.[5] To reduce tariffs on regional trade only to replace them with less transparent and often more restrictive rules of origin is a questionable way to achieve the benefits of trade liberalization. See Box 1 on rules of origin and exports of electric appliances from South Africa.

1. Rules of Origin and Internationally Competitive Exporters: Electric Appliances

The South African electrical appliance industry has evolved in response to the opening up of the domestic economy. Production has been rationalized considerably. There is still some production aimed specifically at the protected domestic market. Some is of a relatively simple assembly nature and accounts for correspondingly low levels of employment. At the

[5] See Moran 2001 for a very useful discussion of international supply networks, foreign investment and the costs of local content requirements and similar performance requirements.

other extreme are examples of internationally competitive export production, which account for much higher levels of employment than domestically oriented sales. One domestic company now accounts for about 4 percent of the entire global market for electric kettles.

Export production is very competitive. Exporters of electric appliances prefer locally sourced components when they can be supplied competitively. But local sourcing varies considerably across products. To remain competitive they must have the flexibility to source anywhere in the world. Internationally branded vacuum cleaners exported to the Middle East use motors from Italy. Simple cord sets for kettles and other exports are sometimes sourced domestically and sometimes from as far away as China. *It is the flexibility to source from anywhere that permits them to remain competitive.*

A proposed SADC rule of origin requiring 60 percent local content could be met for some products. A 45 or 50 percent rule would broaden the range of possibilities. But a 35 percent rule would be much preferred. This would provide the kind of flexibility currently used to compete in the much larger and much more interesting global market.

Restrictive rules of origin are a hindrance, not a benefit, to internationally competitive exporters.

Source: based on material in Flatters 2002b.

While rules of origin are needed in all regional free trade areas, they might best be thought of as a necessary evil. Even the simplest and most transparent of rules add to the transactions costs of liberalized trade. When rules are designed to achieve other purposes, especially to provide protection against the increased competition arising from tariff preferences, the end result can be not much better than and even worse than in the complete absence of a regional free trade area.

As with the problem of trade diversion, however, the dangers arising from rules of origin depend very much on the approach taken to the design of the preferential arrangements. An open approach which confines the use of rules of origin to simple authentication poses very little danger. However, a fortress approach in which rules of origin are employed for protection and other 'developmental' purposes can turn regional trade agreements into a major hindrance to global integration and sustainable development of member states. See Box 2 on contrasting rules of origin regimes in SADC and COMESA.

2. Rules of Origin in SADC and COMESA: A Tale of Two Regimes

From its inception COMESA adopted a set of simple and transparent rules of origin, requiring either change of heading or quite unrestrictive requirements on minimum amounts of regional value added or maximum import content. Recognizing the trade facilitation benefits of adopting a similar regime, especially in light of overlapping membership with COMESA, the original SADC Trade Protocol specified very similar rules.

The original SADC rules included both general conditions stipulating that simple packaging, assembly and labeling, for instance, are insufficient to confer originating status (Rule 3 of Annex I to the Protocol), and specific rules setting out minimum levels of economic activity. Under the specific rules goods would qualify for SADC tariff preferences if they underwent a single change of tariff heading, contained a minimum of 35 percent regional value-added, or included non-SADC imported materials worth no more than 60 percent of the value of total inputs used. Agricultural and primary products would need to be wholly produced or obtained in the region.

Certain Member States then pressed for exceptions to these rules. The arguments for these exceptions were varied, but many of them boiled down to attempts to increase protection in domestic markets. This has led to a rule of origin regime in the amended Trade Protocol that is very different from what was originally agreed, characterized by 'made-to-measure' sector-specific rules that are far more restrictive. The change of tariff heading requirement has been replaced by multiple transformation rules and/or detailed descriptions of required production processes. Value added requirements have been raised considerably, and permissible levels of import content have been similarly decreased.[6]

The rules are now much more like those in PTAs with rich, highly industrialized countries. The greatest similarity is with respect to the rules in the EU-South Africa and EU-ACP trade agreements. This is no coincidence. The EU-South Africa rules were often invoked by special interests in South Africa as models for SADC. Such claims were too often accepted at face value and not recognized as self-interested pleading for protection by already heavily protected domestic producers. There were few questions about the appropriateness of the underlying economic model (whatever it might be) for SADC.

The SADC rules are highly restrictive, to the extent that they will virtually rule out the possibility of preferential trade in a wide variety of sectors deemed 'sensitive' by particular vested interests. These rules of origin are likely to undermine most of the potential trade benefits that might arise from preferential tariff reductions.

It is especially ironic that COMESA, which originally decided to relax some of its rules of origin to make them consistent with the original SADC rules, is now under pressure from certain interests to abandon its simple and transparent regime in favor of one more similar to SADC's.

Source: Flatters 2002b

Unlike trade diversion, however, problems with rules of origin cannot normally be solved through the unilateral actions of individual members. Any member of a regional free trade agreement can minimize its own costs of trade diversion through unilateral reductions in MFN tariffs. This is not the case with rules of origin that are commonly agreed among all member states.

Infant Industries and Scale Economies

For regional integration to assist in promoting development it must foster the growth of competitive industries. There are two strongly conflicting views on how this might be achieved, and they have quite different implications for the design of a regional integration strategy.

According to the (temporary) fortress view, a major function of a free trade agreement is to provide an expanded regional market within which industries can reap the

[6] The amended Trade Protocol had replaced the original one before the Protocol was actually implemented. Therefore the relatively simple and liberal rules in the original Protocol never were applied in regulating intra-SADC trade.

benefits of greater economies of scale than available in a single domestic market, but still remain protected from global imports. The strategy relies on reduction of barriers to intra-regional trade, but retention of significant protection against extra-regional competition. This is a simple variation of traditional import-substitution development strategies. This approach flies in the face of the overwhelming evidence referred to earlier about the importance of openness to economic growth and poverty reduction.

In the African context, however, it is observed that the continent suffers from the existence of too many small, underdeveloped and fragmented markets. Regional integration initiatives that reduce this fragmentation by removing tariffs and other barriers to intra-regional trade cannot fail to help, at least in the right circumstances. But can they help in an environment in which external trade is severely restricted?

While the African continent is extremely large, the size of any of its regional markets is not. All of SADC is smaller than Turkey, and 75 percent of this is accounted for by one country alone, South Africa.[7] Can a sustainable long term development strategy be based on access to such a market alone? Even more important than the small scale of the market for final goods is the dearth of supply of competitive raw materials and intermediate inputs.

All of Sub-Saharan Africa has a market size smaller than Australia. Almost half of this is accounted for by the two widely separated economies of South Africa and Nigeria. And no matter how successful policy makers might be in reducing policy impediments, intra-regional trade will still be hindered by the enormous natural barriers of geography.

Regional markets do not offer great hope for exploitation of economies of scale, especially in relation to the alternative of access to developed, global markets. The US market alone is almost 10 times larger than all of Sub-Saharan Africa.

When participating in world markets scale no longer needs to be a barrier. To be able to compete and take advantage of these potential economies of scale, however, depends on fast, flexible and low cost access to global supply networks for raw materials and intermediate inputs. The first requirement for this is free and open trade with the international economy. The lessons from the 'miracles' of East and Southeast Asia and from successful export experiences in Africa are best described as import-led growth, not export-led growth. See Box 3 on import-led growth in Mauritius.

3. Mauritius: An Import-Led Growth 'Miracle'

At independence Mauritius' economic prospects were very bleak.[8] It was among the poorest countries in the world. Its population was too high to be supported by the limited land and natural resources available on the island. Any wage sufficient to induce landowners to hire the available labor force would be too low to support even a bare subsistence standard of living. Under existing economic structures, the only hope was in the emergence of

[7] See Flatters 2002b.
[8] See Meade 1964 for an elegant and highly readable overview of the findings of British government-commissioned studies at the time.

technologies that would permit large increases in sugar yields, or significant increases in world sugar prices. Neither of these was very likely. Mauritius appeared to be stuck in a classic Malthusian trap, condemned to grinding poverty, almost inevitable ethnic strife and resulting political and economic instability. It seemed to be a hopeless case.

Thirty years later Mauritius would be unrecognizable to those who participated in British-commissioned studies at the time of her independence. Per capita income (PPP adjusted) is more than 5 times higher than the average for Sub-Saharan Africa and more than two and a half times that of all developing countries. Rates of growth outperform these other groups by a wide margin. Other human development indicators show similar differences.

Central to this achievement have been:

- recognition of special opportunities available in world markets, and
- trade promoting policy reforms – facilitation of the import of raw materials and the export of processed products, with the absolute minimum of regulation and conditions attached.

Outward oriented investors in Mauritius were permitted to import whatever they wanted, from whatever source they wished, to engage in any processing of these materials that they were able to do economically in Mauritius, and to export the resulting products to any market in the world.

At the same time, trade policy over the same period has seen the continuation of relatively high rates of protection to a wide range of import substitution industries. Until very recently, the tariff structure has been characterized by high and variable rates, with an escalating pattern that encouraged inefficient local assembly industries. A long-entrenched myth about the importance and fragility of such import substitution industries perpetuated a high cost policy regime for an unusually long time.

It is only relatively recently, after recognizing the small amounts of employment in these industries and the high costs they impose on consumers, and after introducing a VAT which reduces reliance on import duties for government revenue that Mauritius has begun to rationalize its tariff regime.[9]

It is a testimony to the effectiveness of the EPZ system and to the market-friendliness of the rest of the investment and industrial policy regime that the export-oriented economy in textiles and a variety of other sectors was able to develop so successfully in spite of these import substitution measures. Mauritius now exports a wide range of manufactured products, including of course garments and textiles, but also sunglasses, watches and their parts, medical equipment and many other goods. In addition she continues to earn considerable income from tourism, and has begun to export banking and information processing services.

One of the major achievements of this 'miracle' was enormous new job creation in outward oriented manufacturing. As a result, Mauritius is now facing labor shortages rather than surpluses; wages and skill levels have risen to the point that Mauritius is rapidly losing its comparative advantage in labor intensive manufacturing. Mauritius is now graduating from low skill manufactures to exports of more skill-intensive products. It has become a regional growth engine – a hub for coordination and logistical support of production and exports of a wide range of services and manufactures, including many related to the textile and garment value chain.

Mauritius is an African example of the gains from participation in global markets. Central to its success has been a policy environment which has made trade as easy as possible and has

[9] See Box 7 of Flatters 2002b.

permitted investors, domestic and foreign, to engage in activities that could be done best in Mauritius.

Source: based on material in Flatters 2002b.

While regional trade liberalization can certainly be helpful in integrating small economies with the global economy, this is not generally sufficient to ensure sustainable development of competitive manufacturing industries. Liberalizing regionally without complementary measures to increase access to global supply networks will make it very difficult to develop new industrial strengths.

Capture by Special Interests

All trade negotiation processes are subject to pressure from special interests. This is especially true of those who have become accustomed to semi-monopolistic positions that are preserved by barriers to external competition. The voices of countervailing interests of those who might benefit from increased competition and availability of imported goods are generally much weaker. Consumers who suffer from high domestic prices have much less interest in fighting any particular tariff or other trade restriction. And potential exporters whose competitiveness is impaired by lack of access to supply networks might not even be represented as a result of existing cost barriers.

Policy makers in small, heavily protected regional markets are especially vulnerable to capture by such interests in regional trade negotiations. Self-interested pleading for 'infant industry' protection can be very effective when policy makers are struggling to promote industrial development. Inclusion of infant industry clauses in regional agreements opens policy makers to pressure from actual or would-be monopolists offering false promises of income and employment growth. See Box 4 on wheat products in Namibia.

4. Rent-Seeking and Infant Industries in SACU: Namibian Pasta

The Southern Africa Customs Union (SACU) agreement includes a provision for the protection of new domestic 'infant' industries. Namibia chose to take advantage of this provision in the pasta sector prior to the implementation of the SADC Trade Protocol.

The SACU MFN tariff on pasta is 25 percent. At the request of the local flour milling group that wished to build a new pasta factory, the government agreed to impose an additional import duty of 40 percent, to remain in place for four years and then be phased out gradually over another four years. Since the milling branch of the company gets wheat on a duty-free basis, its flour is also effectively duty-free, except for any excess of its milling costs over those of international mills.

The factory was completed in 2002 and is operating at almost 100 percent of capacity – three shifts, seven days a week. It is obviously a commercial success. This should not be surprising in light of the very high levels of protection given. The effective rate of protection *vis à vis* South African producers is about 89 percent while *vis à vis* international competitors it is about 425 percent (based on cost data from the firm).

Other than rents created for the (South African owned) firm, what benefits does the infant industry protection give to Namibia?

Namibia is an extremely tiny participant in the world wheat market. Small increases in demand for local wheat do not affect the price received by farmers. They receive no more than the import parity price (and usually less) regardless of local demand.

What does the new pasta factory provide for consumers? Increased import duties ensure that consumers have much less choice in buying pasta. The factory employs a special high temperature process that allows the use flour milled from inferior local wheat rather than durum wheat. This gives a product that is acceptable to some consumers, but disagreeable to many others. A tour of local supermarket shelves reveals only the local brand. 'Specialty' pasta ('normal' pasta in most other markets) has to be bought at very high duty-inclusive prices in a few shops. High prices and low sales volumes have made this an unprofitable product for most supermarkets to stock.

What about employment? The pasta factory operating at full capacity with three shifts employs a total of 20 workers (10 less than the minimum promised when applying for infant industry protection). But this low number does not even represent the net job creation from the factory. Prior to the establishment of this factory, another local pasta producer served the local market with pasta made from flour purchased from the milling company that now operates the new pasta plant. Shortly after the new pasta plant commenced production, the old producer's line of credit was revoked and the factory was forced to close. Data have not been obtained on the number of job losses this caused. But it can be stated with certainty that the net number of jobs created by this infant industry protection is less than 20.

Source: Erasmus and Flatters 2003.

Similarly, producers of heavily protected consumer goods sold in local markets can make plausible but fundamentally incorrect arguments about the need for restrictive rules of origin based on inapplicable models taken from elsewhere. See Box 5 on the background to SADC rules of origin for garments.

5. Sourcing by Garment Producers: Current Practices and SADC Rules of Origin

SADC has agreed on the highly restrictive double transformation rule as the standard for garments to qualify for SADC tariff preferences. That is, in order for regionally produced garments to qualify for such preferences they must be made from regionally produced fabric. The stated rationale for this rule is to use the Trade Protocol to encourage the development of regional input supplying industries, and that this was the same rule as used in the EU-South Africa trade agreement. This view was put forward especially forcefully by South Africa, which has the region's best developed spinning, weaving and knitting industries.

What is the current practice of South African garment producers, when producing for the domestic and international markets?

When producing for export, South African garment producers can qualify for duty exemptions or duty rebates on imported fabrics and yarns, and/or for duty credit certificates in respect of their exports which can then be used to secure imported inputs. It is not surprising, therefore, that South African garment exporters use almost entirely imported fabrics in their export production.

Even when producing for the domestic market, South African garment makers rely heavily on imported fabric. Domestic demand is influenced by international fashion trends in both design and materials. Retailers must respond accordingly. A supplier of garments to one of South Africa's major retail chains buys 90 percent of its fabric internationally. It would prefer to source a higher proportion locally and in fact has made a number of attempts to increase the degree of local sourcing. On several recent occasions it was seriously let down by quality problems and delivery delays when trying to expand its local supply network.

When asked how the company would respond to a requirement that its garments be made from domestically or regionally produced fabric, the owner replied: "We could not compete; we would shut our doors tomorrow." This is despite import duties of 40 percent on its products.

Another manufacturer of brand name apparel uses Italian cotton fabric for its high end products. Such fabric cannot be obtained from a South African producer at any cost.

If these are the current practices of South African garment producers, how much regional production is likely to qualify for SADC preferences under the current double transformation rule? Very little. It is apparent that almost no regional production would qualify for SADC regional preferences under the current rule. The real reason for this rule of origin is to ensure that local garment producers will face no new competition as a result of intra-regional tariff reductions.

Source: Flatters 2002a.

Rent-seeking and trade negotiations are inseparable partners. This is especially true of regional agreements among partners with small, imperfectly competitive and often heavily protected domestic markets. A strong and clear vision of regional trade liberalization as an element of a broader set of policies to promote global integration is necessary to resist rent-seeking behavior that will lead the process in a contrary direction.

3.3 Regionalism in the Multilateral Framework

The WTO framework is ambiguous in its treatment of regional trade arrangements. Absolutely central to the GATT/WTO processes, of course, has been the principle of non-discrimination, or the MFN principle. The preferential nature of regionalism makes it an exception. As such, it has been necessary to provide legal rules that attempt to circumscribe the practice (Article XXIV of the GATT, reinforced by its Understanding of the Uruguay Round agreement and Article V of the GATS). In practice, these rules have not been seriously tested, and there have been extremely few instances in which regional arrangements have been found to be in violation.

Part of the problem is lack of clarity in the rules themselves. The Understanding of Article XXIV in the Uruguay Round did not assist in this regard. The share of total regional trade that must be reciprocally liberalized remains open to interpretation, as does the determination of the level of protection afforded in a new Customs Union that would be considered to be no more restrictive than former MFN rates of individual members.

As the discussion in the previous section suggests, there would be considerable economic merit in clarifying and adding to the restrictions placed on regional agreements. There can be little doubt about the benefits of disciplines on preferential rules of origin, an area in which the WTO has made almost no progress. Restrictive, non-transparent and administratively costly rules of origin should not be allowed to replace tariffs as a barrier to trade among countries subscribing to preferential trading arrangements. Nor should they be used to impose an inappropriate development model as a condition for developing countries to gain access to preferences in developed country markets. Provisions to accomplish this objective would be a useful addition to Article XXIV and would most beneficial to the least developed members of preferential agreements. To this should be added some disciplines on other non-tariff barriers and procedures for dealing with non-compliance with these and other provisions.

The growth of regional preferential trading arrangements makes a thorough review of the MFN principle and its apparent conflict with regionalism a matter of urgent necessity. Such a review would give serious consideration to the benefits, costs and economic imperatives underlying both the MFN principle and the emergence of regional trading arrangements, with a view to achieving a regime which supports global integration and sustainable development of all countries, rich and poor.

4. Unilateralism: The Importance of National Level Policies

Multilateralism and regionalism are instruments that can be used to pursue the important national goal of increasing the degree and effectiveness of a country's participation in the global economy. Neither should be taken as a goal or as an obligation in its own right. It is the national economic interest that should be paramount in strategies for regional and multilateral integration.

The WTO is not necessary for many of the most useful things that should be done in most countries. Nor are regional cooperation agreements. But they can both be helpful.

Unilateral decisions made by domestic policy makers on the basis of enlightened national interest are the key to successful trade and industrial policies. For developing countries in Africa, the greatest potential benefits will derive from policies that can be made and implemented unilaterally. This is true not only of standard issues like tariff reduction and removal of remaining non-tariff barriers to imports and exports. As the recent research has indicated (World Bank 2002), even greater economic gains might be available through liberalization and deregulation of key service industries. As the coverage of this report indicates, there is also considerable scope for improvement, at both national and regional levels, on an even broader range of 'behind the border' issues.

It is not necessary to travel to Geneva, Brussels, Washington or Cancun to deal with these issues.

Unilateralism, of course, is not inconsistent with participation in the WTO and regional cooperation agreements. But it is the national interest that should guide such participation. As the earlier discussion has shown, there are many potential pitfalls in both multilateral and regional processes. But these can be avoided through policies that are based on careful consideration of domestic interests. In this way, it is possible both to improve domestic policies and maybe also to increase the effectiveness of regional and multilateral rules and institutions.

Despite being included as full and equal partners in the WTO, developing countries have not been very effective participants. This is not difficult to understand. Individual developing countries have little bargaining power. A rational examination of the benefits and costs for a particular developing country in lobbying the US and EU would suggest that the benefits are small. There are great asymmetries between strong and powerful lobbies in the big rich countries and the interests and capabilities in any particular poor country. And the difficulties and costs of coordinated action by groups of developing countries are also considerable.

This is not meant to be a counsel of despair in approaching relationships with and participation in the WTO. But it should be taken as a warning to be realistic. Developing countries gain a great deal from the WTO regime, and they can and will make a difference in shaping its future.

African countries have more influence in the design of their own regional institutions and trade arrangements. Evidence on the effectiveness of this influence so far is mixed. Regional arrangements are not a substitute for MFN-based domestic reforms. Regional trade liberalization and cooperation should be seen as a complement to policy improvements at the national level, whether undertaken as 'obligations' under the WTO or as self-interested reforms above and beyond such commitments.

Small developing countries can do a great deal for their citizens, and especially the poor, through measures that are under their own control – that is by improving their own trade policies. This means finding ways to resist the pleas of rent seekers and the peddlers of bad economic ideas, and drawing on the lessons of international experience to promote domestic trade policy improvement – at the border and behind the border. Beyond that, regionalism and multilateralism can be viewed as useful complements to this process and should be guided by the same vision of the domestic interest in integrating effectively with the global economy.

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