

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

# GLOBAL AND REGIONAL APPROACHES TO TRADE AND FINANCE



UNITED NATIONS



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UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT  
GENEVA

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UNITED NATIONS

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***Classification by country or commodity group***

The classification of countries 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 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 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 2007* refers to *Trade and Development Report, 2007* (United Nations publication, sales no. E.07.II.D.11).

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

The term “billion” signifies 1,000 million.

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.

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.

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

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**Abbreviations**

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ADB	Asian Development Bank
AfDB	African Development Bank
CIS	Commonwealth of Independent States
ECLAC	Economic Commission for Latin America and the Caribbean
EMU	European Economic and Monetary Union
EU	European Union
FDI	foreign direct investment
FTA	free trade agreement
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GNP	gross national product
IDB	Inter-American Development Bank
IMF	International Monetary Fund
IT	information technology
LIBOR	London interbank offered rate
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
RTA	regional trade agreement
TDR	Trade and Development Report
TNC	transnational corporation
UN/DESA	United Nations Department of Economic and Social Affairs
UNCTAD	United Nations Conference on Trade and Development
WTO	World Trade Organization

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**List of regional blocs and membership**


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<b>ANCOM</b>	<b>Andean Community of Nations (Comunidad Andina de Naciones)</b> Bolivia, Colombia, Ecuador, Peru, Venezuela (Bolivarian Republic of) (until 2006)
<b>ASEAN</b>	<b>Association of Southeast Asian Nations</b> Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, Viet Nam
<b>ASEAN+3</b>	<b>Association of Southeast Asian Nations +3</b> ASEAN plus China, Japan and the Republic of Korea
<b>CACM</b>	<b>Central American Common Market (Mercado Común Centroamericano)</b> Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua
<b>CARICOM</b>	<b>Caribbean Community</b> 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
<b>CEMAC</b>	<b>Economic and Monetary Community of Central Africa (Communauté Economique et Monétaire de l'Afrique Centrale)</b> Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea, Gabon
<b>CFA franc zone</b>	<b>Coopération Financière en Afrique Centrale/ Communauté Financière Africaine</b> CEMAC and UEMOA member States
<b>CIS</b>	<b>Commonwealth of Independent States</b> Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Republic of Moldova, Russian Federation, Tajikistan, Turkmenistan, Ukraine, Uzbekistan
<b>CMA</b>	<b>Common Monetary Area</b> Lesotho, Namibia, South Africa, Swaziland

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<b>COMESA</b>	<b>Common Market for Eastern and Southern Africa</b> 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
<b>ECOWAS</b>	<b>Economic Community of West African States</b> Benin, Burkina Faso, Cape Verde, Côte d'Ivoire, Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Niger, Nigeria, Senegal, Sierra Leone, Togo
<b>EU-15</b>	<b>European Union-15</b> Austria, Belgium, Denmark, Germany, Greece, France, Finland, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, the United Kingdom
<b>EU</b>	<b>European Union</b> EU-15 plus Bulgaria, Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovakia, Slovenia
<b>GCC</b>	<b>Gulf Cooperation Council</b> Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates
<b>LAIA</b>	<b>Latin American Integration Association (Asociación Latinoamericana de Integración)</b> Argentina, Bolivia, Brazil, Cuba, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay, Venezuela (Bolivarian Republic of)
<b>MERCOSUR</b>	<b>Southern Common Market (Mercado Común del Sur)</b> Argentina, Brazil, Paraguay, Uruguay
<b>NAFTA</b>	<b>North American Free Trade Agreement</b> Canada, Mexico, United States
<b>SAARC</b>	<b>South Asian Association for Regional Cooperation</b> Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, Sri Lanka

<b>SACU</b>	<b>Southern African Customs Union</b> Botswana, Lesotho, Namibia, South Africa, Swaziland
<b>SADC</b>	<b>Southern African Development Community</b> Angola, Botswana, the Democratic Republic of the Congo, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, South Africa, Swaziland, the United Republic of Tanzania, Zambia, Zimbabwe
<b>UEMOA</b>	<b>West African Economic and Monetary Union (Union Economique et Monétaire Ouest Africaine)</b> Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, Togo
<b>WAMZ</b>	<b>West African Monetary Zone</b> Gambia, Ghana, Guinea, Nigeria, Sierra Leone

# I. INTRODUCTION

A coherent treatment of the interdependence between trade, macro-economic and financial issues was an important element in the debate leading to the post-War international economic system. The set-up of the post-War international trade regime was predicated on the belief that, in conditions of strictly limited private international capital flows, an international monetary system with convertible currencies at fixed, but adjustable, exchange rates would provide a stable environment conducive to trade and investment. Under the aegis of the General Agreement on Tariffs and Trade (GATT), this regime considered tariffs as the only legitimate trade policy measure. The adopted exchange rate regime supported the GATT approach, as participants in international trade negotiations could predict the full extent to which the competitive position of domestic industries would be affected by tariff cuts without having to be unduly concerned about other exogenous factors.

The specific problems of developing countries participating in the post-War international trading system were largely absent from the mandates of the intergovernmental institutions created immediately after the Second World War. This was despite the fact that, with international private capital flows constrained and official development assistance still limited (and often tied), the role of international trade was attracting increasing attention as a dependable means of removing the resource constraints on economic growth in developing countries. Multilateral efforts at designing a trading system that would take account of the policy options of developing countries, for which slow growth and adverse terms-of-trade movements were distinctive features, culminated in the First United Nations Conference on Trade and Development in 1964. The Report to the Conference spelt out a

strategy designed to help poorer countries develop outwardly through strong capital formation and continuing and accelerated expansion of exports – both traditional and non-traditional. Central to that agenda was the idea that developing countries can base economic development on their own efforts only if they have sufficient policy space to accelerate capital formation, diversify their economic structure and give development greater “social depth”. This agenda also emphasized the interdependence between trade and finance, given that, particularly in the early stages of industrialization, imports would almost certainly grow faster than exports, and financing the gap would be key to accelerating growth.

The need for coherence between the international trading system and the international monetary and financial system has gained in importance with the abandoning of the system of fixed, but adjustable, exchange rates and the adoption of widespread floating, combined with a return of private international capital flows to levels similar to those that had caused much economic and social instability in the inter-war period. In particular, the liberalization of capital movements has, on balance, had little impact on levels of development finance, and the balance-of-payments constraint of developing countries has not been removed. Rather, there has been a de-linking of financial flows from international trade. This is most clearly the case with short-term flows, where over 80 per cent of transactions relate to round-trip operations, motivated by hedging, arbitrage and speculative considerations. Moreover, the increased level and volatility of short-term private international capital flows, associated with the often sharp swings in exchange-rate expectations of international investors, have an adverse bearing on the principle of non-discrimination in trade and on developing-country trade performance.

Thus, an evaluation of the trade performance of developing countries should take account not only of the functioning of the international trading regime itself, but also of the way international monetary and financial relationships impact on trade. This is the subject of this book.

The first part examines the problem of insufficient coherence between the international trading, monetary and financial systems, and how it affects the formulation and successful implementation of national development



strategies. It is argued that rapid financial liberalization, inasmuch as it makes developing countries vulnerable to sharp and abrupt shifts in the direction of largely autonomous short-term private international capital flows, can have negative effects on their trade performance. Managed currency depreciations, proceeding on a smooth, long-term basis, can strengthen the international cost competitiveness of domestic exporters and generally improve developing countries' trade performance. However, this is not the case for the sharp and abrupt exchange-rate depreciations that have occurred in many financially open developing countries over the past three decades; they did not result in proportionally larger improvements in trade performance. This is because they were often accompanied by sharp declines in imports and reduced access to trade finance and working capital, which compromised the ability of domestic exporters to benefit from their increased international cost competitiveness stemming from the depreciation. The final section outlines a multilateral solution designed to avoid international monetary and financial upheaval and thereby support developing countries' trade performance and foster their domestic supply capacities.

The second part of the publication starts from the recognition that as long as such a multilateral solution is absent, regional cooperation among developing countries can be a way of fostering the creation of domestic supply capacity, developing countries' trade performance and their resilience to international monetary and financial shocks. It is argued that regional cooperation among developing countries does not only have the potential to support national development strategies, but also to some extent fill the gaps in the global economic governance system. But in order to do so it has to extend beyond regional trade liberalization to include policy areas that strengthen the potential for growth and structural change in developing countries, particularly macroeconomic and financial management. In this respect, regional monetary and financial cooperation can 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 macro-economic surveillance. However, 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. On the contrary, successful regional financial cooperation among developing countries may be one of the building blocks of an improved international monetary order. 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.

## **II. FOSTERING COHERENCE BETWEEN THE INTERNATIONAL TRADING, MONETARY AND FINANCIAL SYSTEMS**

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### **A. Building the international competitiveness of developing-country exporters**

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Developing countries depend on a favourable international trading environment to reap the full benefits of their integration into the world economy. Equally important for their successful integration is the creation of strong supply capacities. An essential lesson from the experiences of countries that combined successful integration into the world economy with sustained growth is the critical role of active and well sequenced policies to augment the existing stock of physical and human capital, enable the use of more efficient technologies, and shift resources from traditional, low-productivity activities towards activities that offer a high potential for productivity growth.

Transformation of the production structure requires entrepreneurs who are capable and willing to invest in activities that are new to the domestic economy. Indeed, Schumpeter (1911) pointed to the importance of innovative investment for economic development, and Baumol (2002) argues that innovation, and the consequent rise in productivity, account for much of the extraordinary growth record that has occurred in various parts of the world since the Industrial Revolution. He suggests that market pressures arising from oligopolistic competition force firms to integrate innovative

investment into their routine decision processes and activities – thus, the innovation process is neither largely autonomous nor largely fortuitous. Market forces achieve much of this through financial incentives, by providing higher pay-offs to those firms that are more efficient and whose products are most closely adapted to the wishes of consumers.

However, the occurrence of innovative investment is not automatic; it could encounter structural and institutional impediments. Moreover, the macroeconomic environment could be inappropriate for encouraging and supporting investors seeking to create or expand productive capacity and, in particular, to increase productivity and international competitiveness. The main incentive for investors to discover a more efficient way of producing an existing good or to produce a new good arises when they can appropriate at least part of the rent generated by the creation of new knowledge. Within this framework, for an innovative entrepreneur to enjoy such benefits, a number of conditions must apply at different levels. These conditions relate to a wide range of linkages between investment, productivity growth, successful integration into the international trading and financial systems, and economic development, which in recent years have often been seen through the lens of international competitiveness.

The concept of competitiveness can contribute to an understanding of the distribution of wealth, both nationally and internationally, if it is recognized that: (i) it can be applied at both the enterprise and the country level, (ii) when applied at the enterprise level, it relates to profits or market shares, (iii) when applied at the country level, it relates to both national income and international trade performance, particularly in relation to specific industrial sectors that are important in terms of, for example, employment or productivity and growth potential, (iv) it is based on a Schumpeterian logic that sees the nature of capitalist development as a sequence of innovative investments associated with dynamic imperfect competition and productivity gains, and that sees a major role for public policy in facilitating productivity-increasing investment,<sup>1</sup> and (v) not all countries can simultaneously improve the competitiveness of their firms or sectors relative to other countries, but all countries can simultaneously raise productivity and wages to improve their overall economic welfare without altering their relative competitive positions.

If new technology in the form of added capital per worker (or embodied technological change) is at the heart of the development process through which nations become rich, and if embodied technological change is driven by investment based on either innovation of domestic entrepreneurs or putting imported capital equipment to efficient use, then approaching the concept of competitiveness in the context of economic development needs to take account of the interdependence of investment, trade, finance and technology.

Looking at competitiveness from the perspective of interdependence, two key questions relate to how different price, wage, exchange rate and trade arrangements (i) influence the determinants of innovative investment, and (ii) determine whether productivity gains of individual firms translate into benefits for the overall economy, as reflected in rising living standards, while maintaining external balance.

Emphasizing interdependence also implies that competitiveness in international markets is determined by both real and monetary factors. Competitiveness may increase as a result of the relatively strong productivity performance of companies or the national economy as a whole. But greater competitiveness can result also from a depreciation of a country's real effective exchange rate following either a depreciation of its nominal effective exchange rate or a smaller rise in the ratio between wages and productivity (i.e. unit labour costs) than in other countries.

There have been strong objections to the use of the concept of competitiveness at the level of countries rather than at the level of individual firms. Some of these objections raise valid concerns. Indeed, caution is needed in presenting the concept as one of the economic challenges facing developing countries.

Nonetheless, developing countries have valid concerns about their external economic performance. First, countries in the early stages of industrialization require foreign-exchange earnings from exports to finance machinery and equipment imports that enable innovative investors to obtain productivity gains. Second, countries further advanced in industrialization, and strongly integrated into international trading and financial markets,

may find it difficult to maintain a sufficient degree of flexibility in their monetary, wage and trade policies. Flexibility is needed to accommodate price adjustments that arise from productivity-enhancing investment and to prevent profits earned through innovative investments from being spent on luxury imports rather than being reinvested. Third, and most importantly, changes in the relative importance of different economic sectors are a key factor for rapid and sustained productivity growth and higher living standards. This implies that the concept of competitiveness is of immediate policy relevance. It can be used to analyse under which conditions productivity gains at the microeconomic level translate into structural change at the level of the national economy and enable upgrading of the technology content of a country's export basket. It is also useful for identifying policy measures that reduce the vulnerability of national economies to disturbances emanating from the international economy and which may have adverse effects on national economic development.<sup>2</sup>

Given the complexity of the issue of competitiveness, it is not surprising that there is a multitude of competitiveness indicators. Some analysts use competitiveness indices that combine several dozens of individual measures spanning across a wide range of economic and non-economic factors.<sup>3</sup> However, the indicator that is most widely used in applied economic analysis is the real exchange rate, based on either relative consumer price or relative unit labour cost indices expressed in a common currency.

### **1. *Conditions for competitiveness at the microeconomic level***

Linkages between capital accumulation, technological progress and structural change constitute the basis for rapid and sustained productivity growth, rising living standards and successful integration into the international economy. Investment holds a central place in this interplay, because it can simultaneously generate income, expand productive capacity, and carry strong complementarities with other elements in the growth process, such as technological progress, skills acquisition and institutional deepening.

However, a given rate of investment can generate different growth rates, depending on its nature and composition as well as the efficiency with which production capacity is utilized. Particularly important for productivity growth and structural change is investment in new techniques and/or new products. This is because new procedures generally reduce production costs of established products, while new products are often more attractive to consumers than any of the previously available alternatives. Assuming constant wages, successful innovative investment will be reflected in growing market shares, if the investor chooses to pass on innovation rents in the form of lower prices; or it will lead to (temporary) monopoly profits, if the investor chooses to leave sales prices unchanged and enjoy innovation rents from the rising revenue-cost ratio until competitors succeed in imitating the innovator. Which mix of these two polar strategies the investor chooses will depend on the intensity of competition. This means that in the microeconomic sphere, changes in competitiveness relate to changes in relative labour productivity across different firms, and that technological progress and the ensuing growth in labour productivity (i.e. the drivers of sustainably rising competitiveness) are associated with oligopolistic, rather than perfect, competition.

Innovative investment in developed countries extends the technological frontier. By contrast, in developing countries it generally relates to the adoption, imitation and adaptation of technology invented elsewhere. While this does not affect the key importance of productivity-enhancing investment for competitiveness at the firm level, or significantly alter the determinants of investment decisions, there are three issues that specifically concern productivity-enhancing investment in developing countries. First, in building their industrial capacity and competitive strength, newly industrializing countries must typically import a large volume of capital goods and intermediate inputs. However, an inability to obtain additional export earnings (i.e. if the country's products are not competitive on international markets or face prohibitive market access or entry barriers), and thus to finance these imports, may be a serious constraint on the industrialization process. The extent of this balance-of-payments constraint and dependence of developing countries on foreign technologies embodied in imported capital goods are perhaps greatest during the initial stages of industrialization. However, the need for large-scale imports of machinery and equipment persists throughout

much of the industrialization process, especially when catching up is based on imitating technological leaders.

Second, in addition to directly facilitating a rise in the level of technology used by domestic firms, developing-country imports of goods that embody foreign technology positively affect domestic imitation and innovation.<sup>4</sup> For example, a notable feature of the process of technological improvement in the East Asian economies in the early stages of their industrialization was their emphasis on research and development (R&D) spending, not only for backward engineering but also to match or surpass the product quality of foreign manufacturers by adapting and improving imported technology. The former enabled firms, for example, to fully assess the merits of a new foreign technology and thus to determine whether to secure a licence or not, and to unbundle foreign technology, thereby enhancing their bargaining power in negotiating with suppliers. As the industrialization process unfolded and firms came to master imitation, an increasing share of R&D spending was channelled into own innovation (*TDR 1994*, Part Two, chapter one). Taking a wider geographical perspective, and looking at a large number of countries from all developing regions, a recent empirical study (Connolly, 2003) also reveals the positive impact of technology imports from developed countries on domestic imitation and innovation in developing countries.

Third, the realization of technological improvements in developing countries is closely related both to the skill level of their labour force – which determines the amount and degree of sophistication of technology that can be adopted and efficiently used – and to managerial capabilities, which must meet the requirements to function effectively in new sectors and new markets. As such, technological upgrading in developing countries is usually associated with a painstaking and cumulative process of technological learning. Human capital formation, including through learning, is instrumental in preventing a decline in the marginal product of capital, despite the rapid growth in the capital-labour ratio generated by rapid accumulation of physical capital. It also helps prevent a decline in the marginal product of labour, despite the rise in wages that results in a higher standard of living.

The competitiveness of affiliates of foreign transnational corporations (TNCs) is likely to be significantly higher than that of domestic firms.



Labour productivity in TNC affiliates tends to be higher than in their domestic counterparts, because they can combine the comparatively lower general level of labour costs in the host country<sup>5</sup> with the advanced production technology and management techniques used in their home countries, and with supplies of raw materials and intermediate production inputs from the cheapest sources.<sup>6</sup> Indeed, in the context of the concept of competitiveness, the decision of a foreign company to invest in production abroad is generally based on the objective to reduce unit labour costs in production. Setting aside other host country characteristics (such as income or corporate tax treatment or provision of infrastructure), this implies that for foreign direct investment (FDI) to occur, the investor must expect the ratio between labour productivity and wages in the affiliate to exceed that in the parent company. In other words, if expected unit labour costs in the host country are lower than in the TNC's home country, the TNC will consider moving part of its production activities abroad.

## **2. *Competitiveness of firms at the level of the national economy***

At the level of the national economy, the decisive factor for realizing technological upgrading and productivity-driven structural change is the ability of investors to sell the products resulting from their product or process innovations without a significant change in cost conditions (i.e. to enjoy a (temporary) monopoly profit). In other words, if an economy is characterized by high domestic labour mobility and by a similar level of wages for workers with similar qualifications across the economy, its dynamic development will be driven by profit differentials, rather than wage differentials. Indeed, as noted by Keynes (1930: 141), “the departure of profits from zero is the mainspring of change in the ... modern world. ... It is by altering the rate of profits in particular directions that entrepreneurs can be induced to produce this rather than that, and it is by altering the rate of profits in general that they can be induced to modify the average of their offers of remuneration to the factors of production.”

Hence, the closer actual conditions on the labour markets get to the law of one price, the stronger will be the effects of profit differentials on

the evolution of economic systems.<sup>7</sup> The observed asymmetry between uneven productivity growth and the more even growth in wage rates across enterprises or industrial sectors is frequently emphasized as providing an important source of both structural change in the domestic economy and changes in the comparative cost advantages of different countries in specific industrial sectors (see, e.g., Landesmann and Stehrer, 2004). Uneven productivity growth across firms, combined with more even growth in wage rates, implies that workers in industries with relatively high productivity growth are not fully compensated.

Under this scenario, innovative investors may decide to leave sales prices unchanged and obtain a sizeable extra profit equal to the difference between their productivity gain and the economy-wide average growth in productivity. Alternatively, they may prefer to reduce sales prices by the amount to which their cost per unit of output falls, and thus, assuming normal price elasticities of demand, increase their market share. This will lead to a rise in their absolute level of profits in line with the rise in sold output. This potential for extra profits is the major incentive for starting the process of “creative construction” or “destruction” along Schumpeterian lines, and hence for making innovative investments. By contrast, if wages in each firm rise more in line with firm-specific productivity gains, innovative investors will obtain a much lower extra profit, which will be much less of an incentive for innovative investment.

Enterprises whose productivity gains fall short of the national average will experience shrinking profits if labour costs rise at equal rates across firms. These enterprises will therefore attempt to raise the sales prices for their goods so as not to risk a complete erosion of profits.<sup>8</sup> This implies that sectorally uneven productivity gains, combined with even labour cost increases across the entire economy, generate price pressures in non-innovative sectors. However, the net impact of this supply-side effect on price pressure depends on effects originating from the demand side. Rising labour productivity induces increases in income, and hence consumption. If demand for innovated and non-innovated goods were to grow at the same rate, demand effects would not skew price pressure towards one or the other group of goods, thus the supply-side effect would dominate. By contrast, if demand for the innovated good were to grow faster than for the other goods,

the supply-side effect would be offset, partly or completely. And if demand were biased towards goods for which productivity gains were low (such as services), the demand effect would reinforce the supply effect. This will be the case particularly when productivity gains are high in the traded sector, while domestic consumption demand is biased towards non-traded goods.

A second important condition for innovative investment to govern the evolution of the economic system is that firms should have access to reliable, adequate and cost-effective sources for financing their investments. This condition is best met when profits themselves are the main source of investment financing. Indeed, if an investment-profit nexus can be ignited, profits from innovative investments simultaneously increase the incentive for firms to invest and their capacity to finance new investments.<sup>9</sup> When enterprises are heavily dependent on borrowing to meet their needs for fixed investment and working capital, as is the case of new enterprises, the stance of domestic monetary policy is of crucial importance, because high levels of nominal and real interest rates tend to increase production costs. In addition to its adverse impact on the cost of capital, a restrictive monetary policy may bias investment decisions in favour of financial assets, or fixed investment in production activities with known cost and demand schedules over innovative production activities for which investors face uncertainty as to the volume of sales and the true costs of production.

To understand how the mechanisms discussed here work in practice, it is useful to consider a two-country world comprising a developing country, with a low average level of both labour costs and labour productivity, and a developed country, with a high average level of labour costs and labour productivity. Expressed in a common currency, these levels are assumed as 5 and 10 in the developing country and 50 and 100 in the developed country (case 1 in table 2.1). Further, assuming that in both countries the average level of labour costs reflects the average level of labour productivity, firms in both countries face the same average level of unit labour costs (i.e. 0.5 currency units). If labour is the only internationally immobile production factor, these assumptions imply that firms from both countries are, on average, internationally competitive. Moreover, if firms set sales prices on the basis of a mark-up of 100 per cent over labour costs, the absolute level of profits in the developed country will be 10 times higher than in the developing country.<sup>10</sup>

**Table 2.1**  
**INNOVATIVE INVESTMENT, EXCHANGE-RATE CHANGES,**  
**AND INTERNATIONAL COMPETITIVENESS: A NUMERICAL EXAMPLE**

	Case 1		Case 2				Case 3
	No innovative investment		Innovative firm average <sup>a</sup>		Non-innovative firm average		TNC affiliate investing in developing-country export-oriented production
	Developing country	Developed country	Developing country	Developed country	Developing country	Developed country	
Productivity	10	100	12	120	10	100	120 > productivity > 10
Nominal labour costs	5	50	5	50	5	50	5
Unit labour costs	0.5	0.5	0.4	0.4	0.5	0.5	0.5 > ULC > 0.04
Profits per unit of output	5	50	5	50	5	50	115 > profits > 5
Price	1	1	1-x	1-y	1+x	1+y	1-z
<b>1. Unchanged nominal exchange rate</b>							
Export market share	unchanged	unchanged	up	up	down	down	up
<b>2. Nominal exchange-rate<sup>b</sup> appreciation by more than 20 per cent</b>							
Export market share	down	up	down <sup>c</sup>	up <sup>c</sup>	down <sup>c</sup>	up <sup>c</sup>	up
<b>3. Nominal exchange-rate<sup>b</sup> depreciation by more than 20 per cent</b>							
Export market share	up	down	up <sup>c</sup>	down <sup>c</sup>	up <sup>c</sup>	down <sup>c</sup>	up

**Source:** UNCTAD secretariat calculations.

**Note:** x and y are the shares of the innovative investors' products in the total consumption of their respective economies; z is the share of the multinational firm's reimported product in the total consumption of the economy of the parent company.

**a** The scenario in the table is based on the assumption that innovative investors fully transmit gains in profits per unit of output into price reductions.

**b** Developing-country currency/developed-country currency.

**c** The net effect depends on the relation between the gain in productivity and the exchange-rate misalignment. The assumption for the effects noted in the table is that the misalignment is greater than the gain in productivity.

Case 2 in the table introduces the effects of innovative investment by assuming that productivity increases by 20 per cent in innovative firms of both countries. If the weight of these firms in their domestic economies is too small for these productivity gains to have a marked impact on the economy-wide average level of productivity, nominal labour costs will remain unchanged, and unit labour costs in the innovative firms will decline by 20 per cent. Profits per unit of output will also remain unchanged if the innovative firms reduce their sales prices in line with the decline of their unit labour costs. This implies that the innovative firms from both countries will experience an increase in both their export-market shares and their absolute level of profits. By contrast, non-innovative firms will suffer a decline in export-market shares and in profit levels due to the increase in their sales prices relative to those of the innovative firms.

Case 3 in the table shows that affiliates of TNCs can gain considerable advantages in international competitiveness by combining developed-country technology with developing-country labour costs. The level of the affiliate's unit labour costs will be substantially lower than that of either its parent company in the developed country or of domestic firms in the developing country. While it is unlikely that the relatively less educated workers in the developing country can match the productivity level of workers in the developed country, it is probable that the TNC will experience a strong reduction of its unit labour costs by moving its labour-intensive production activities to a low-wage country.

Changes in the nominal exchange rate that are caused by "autonomous" capital flows (i.e. that are unrelated to the flow of goods) can offset the effects discussed above. In case 1, export-market shares will move from firms of the country whose currency appreciates towards firms of the country whose currency depreciates, even though none of the firms has undertaken productivity-enhancing investments and unit labour costs, measured in domestic currency units, have not changed in any of the firms. More importantly, the innovative firms in case 2 will lose, rather than gain, export-market shares if the appreciation of the exchange rate exceeds productivity gains. For example, assuming the currency of the developing country to appreciate by more than the productivity gains achieved by innovative firms, these firms will lose export-market shares to both the innovative and non-

innovative firms of developed countries. This example shows that adverse external monetary shocks can wipe out the gains resulting from an improvement in the international competitiveness of developing-country exporters based on innovative investments and a decline in unit labour costs.

### **3. *Transmission mechanisms between the national and the international economy***

Entrepreneurs invest in the industrial sector of that country in which they expect to realize the highest return on their investment. Cross-country differences in the expected return on investment, expressed in a common currency, are determined by a number of factors, including relative rates of income growth; relative wages and labour productivity; macroeconomic and institutional factors that influence the average level of nominal labour costs in an economy as a whole; relative costs of intermediate production inputs; relative transaction costs associated with information, communications, transportation and distribution; and the use of different currencies. Moreover, market access and entry conditions and the availability of trade finance also determine whether improved cost competitiveness translates into improved export performance. This shows that a wide range of conditions must combine for firms that are competitive on the domestic market to become successful exporters.

First, the availability of adequate transport and communications infrastructure and information systems has a crucial influence on the ability of developing-country firms to conduct trade and to successfully compete in foreign markets.<sup>11</sup> Innovative investors in economies with comparatively high communication, transport and information costs may need to offset this disadvantage by paying lower wages or reducing costs elsewhere in the production process in order to be able to compete in world markets. Firms in countries that are landlocked or geographically distant from major international shipping routes are particularly disadvantaged in this respect. While this is a well-known problem, the impact on trade flows of other forms of trade facilitation, such as the availability of networked information technology and compliance with product standards, has gained in importance over the past few years.

Second, trade finance provides the liquidity for firms to bring their products to the market. Exporters with limited access to working capital often require credit to buy imported raw materials and intermediate production inputs, as well as financing to manufacture products before receiving payments. Trade finance may be provided directly through loans from commercial banks, pre-payments by buyers, and delayed payments by sellers, or indirectly from either export-credit agencies (in the form of guarantees, insurance and government-backed loans), private insurance companies, or multilateral development banks.

Third, assuming constant nominal exchange rates, preserving the international cost competitiveness of domestic firms requires that the ratio of average nominal labour cost growth to average domestic productivity growth in the domestic economy does not rise faster than in the rest of the world. Macroeconomic and institutional factors play an important role in fulfilling this condition. For example, the pressure for sharp general wage increases in an economy approaching full employment is likely to be higher than in an economy with substantial unemployment. Moreover, indexation of wage rises based on factors other than productivity growth is likely to cause substantial and lasting divergence between wage and productivity developments.<sup>12</sup>

Fourth, stable nominal exchange rates are perhaps the single most important condition for the transmission of domestic productivity improvements to gains in international competitiveness. Exchange-rate movements alter the relative competitive position of firms in different countries. On the one hand, this implies that a currency appreciation will wipe out improvements in international competitiveness achieved by innovative firms on the basis of improved labour productivity if the change in the exchange rate exceeds the gain in productivity. If technological progress relies on cumulative and incremental innovations that individually lead to comparatively small productivity gains, it does not take exchange-rate changes of a spectacular size for this to occur.<sup>13</sup> On the other hand, this implies that currency depreciation can give a further boost to the international competitiveness of an innovative firm and maintain the relative competitive position of non-innovative enterprises in the short run. However, there can be little doubt that long-term economic success and maintaining international competitiveness

depend on sustained improvements in productivity. Moreover, resorting to currency depreciation may allow for some breathing space to adjust to changes in the relative competitive position of foreign competitors, but it also entails the risk of igniting a process of competitive devaluations.

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## **B. Impacts of monetary and financial factors on developing countries' export performance**

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Only productivity growth and technological upgrading can ensure sustained improvement in the external balance of developing countries. This can be achieved by a national development strategy that is successful in augmenting the existing stock of physical and human capital, enabling the use of more efficient technologies, and shifting resources away from traditional, low-productivity activities towards activities that offer a high potential for productivity growth. Under some circumstances, and particularly when a period of real currency appreciation has hampered export performance, real currency depreciations can improve international cost competitiveness and boost exports.

The exchange rate has long been recognized as an important policy instrument to make domestic entrepreneurs internationally competitive and provide profit incentives for them to invest in non-traditional export sectors. For example, according to Agosin and Tussie (1993: 22) “The historical record ... shows that ... [a]ll countries that have succeeded in generating a sustained growth of their exports, leading to high rates of growth of output over the long term, have also been able to maintain exchange rates that are attractive to exporters over long periods of time. The exchange rate in such countries has also tended to be fairly stable, enabling producers of tradeables to make long-term investment plans.” In a similar vein, Rodrik (2003) argues that countries grow rich by increasing the range of products that they produce, and not by concentrating on what they already do well. Product diversification requires entrepreneurs who are willing to invest in activities that are new to the local economy, and that process may require positive



inducements. Rodrik (2003: 21) concludes that “a credible, sustained real exchange-rate depreciation may constitute the most effective industrial policy there is.”

For successful trade performance, developing countries need to be able to manage their exchange rates in a way that allows them not only to sustain competitive rates over the longer term, but also to retain enough policy space to be able to make orderly adjustments when faced with exogenous shocks. On some theoretical accounts, a regime of freely floating exchange rates and free capital mobility would enable nominal exchange-rate movements to stabilize real exchange rates. This argument is based on the premise that movements of the nominal rates eliminate temporary disequilibrium in the pricing of goods in different currencies, and that arbitraging currency speculators speed up the adjustment, thus helping to maintain a correct set of real prices on which international traders and speculators can base their decisions (see, for example, Friedman, 1953).

Floating exchange rates between the main reserve currencies were introduced into the international system of trade and finance in the early 1970s. However, orderly balance-of-payments adjustments, increased real exchange-rate stability, greater macroeconomic policy autonomy and removal of persistent currency misalignments and gyrations have not been achieved. This is partly due to the liberalization of capital flows in the last 30 years and to the sizeable increase in the scale and variety of cross-border financial transactions, whose direction can change rapidly in response to shifts in expectations of international portfolio investors. As a result, the currencies of the major developed countries, as well as those of financially open emerging-market economies, have been subject to strong volatility and gyrations, which often represent endogenous responses to large and sharp changes in the direction of international financial flows. These developments are reminiscent of the failure of financial markets to prevent currency disorders and contagion in the 1930s (an insight that was widely accepted as the basis for the attempt to put in place multilateral financial arrangements after the Second World War).

For developing countries, capital inflows, both private and public, can be a source of development finance. However, volatility in international

financial markets, and particularly sharp and abrupt shifts in the direction of largely autonomous short-term private capital flows, have frequently contributed to problems in managing interest rates and exchange rates, and to financial crises including in countries with track records of macroeconomic discipline. Since the early 1990s, a number of developing countries, particularly those that had begun liberalizing their financial markets, have experienced substantial movements in their exchange rates. These movements have frequently been characterized by prolonged periods of exchange-rate appreciation followed by abrupt and sharp devaluations, often associated with a sizeable slowdown in economic activity. These episodes of sharp and abrupt currency depreciations include the well-known currency crises when countries abandoned pegged exchange rates, starting with Mexico in 1994, followed by East Asia (1997–1998), the Russian Federation (1998), Brazil (1999), Turkey (2001) and Argentina (2002). There were also instances of unusually sharp depreciations in countries with more flexible exchange rates, such as Mexico and South Africa in 1998.

The scale of nominal exchange-rate depreciations in many developing countries – even those with a record of macroeconomic discipline – over the past few years has often caused large real exchange-rate depreciations. Given that real currency depreciations can generally be expected to improve a country's trade balance, it could be assumed that sharp depreciations of the real exchange rate will provide an even greater impetus to the international cost competitiveness of domestic exporters and a boost to a country's exports.

The main argument of this section is that the sharpness of recent real currency depreciations brings an additional dimension to the debate on the effect of exchange-rate changes on trade flows. This is because, in the short term, large depreciations of the real exchange rate can seriously compromise the ability of domestic exporters to benefit from their increased international cost competitiveness stemming from the depreciation. Adverse effects occur at two levels. At the level of individual enterprises, it can take the form of a sharp decline in the availability, and/or a strong rise in the cost, of trade finance and working capital. At the macroeconomic level, close trading relationships can provide a channel for the transmission of financial crises and raise the risk of competitive devaluations, which can offset the rise in demand for exports created by the depreciation. Moreover, the steep decline

in economic activity, often associated with sharp and abrupt real currency depreciations, can have an adverse effect on the supply of exports. Such depreciations tend to violate two of the conditions necessary for domestic productivity growth to translate into sustained international competitiveness: access of firms to reliable, adequate and cost-effective sources for financing their investments and stable nominal exchange rates at a level that does not impair the international cost competitiveness of domestic exporters. This section examines more closely the impact that the absence of these two conditions is likely to have on developing-country trade performance.

### **1. *Impacts of exchange-rate changes on enterprise investment and competitiveness***

Uncertainty in currency markets adversely affects many types of economic activities, particularly those that require forward planning and involve decisions that are only reversible, if at all, at high cost. Long-term investment by enterprises in export production capacity is a noteworthy example of such activities, particularly when their production process utilizes imports from third countries. Consider a production unit whose output would be sold in, for example, the United States for dollars, and which would utilize machinery and equipment purchased from Germany, partly on credit denominated in euros, with intermediate production inputs from Japan denominated in yen, and domestic labour remunerated in domestic currency. In such cases, the estimated rate of return on the investment project would be sensitive to the relative exchange rates between the currencies in which the output is to be sold, the currencies in which imported machinery, equipment and intermediate inputs are invoiced, and the domestic currency. The greater the range of exchange-rate variation, the greater is the risk of the project. The project may be profitable only under a given configuration of exchange rates. As a consequence, the investor will realize an extra profit if the exchange-rate configuration evolves favourably, but risk bankruptcy in the opposite case. Firm size and financial strength, diversification of operations across products and markets, managing assets and liabilities in different currencies, as well as the use of other risk management techniques, can limit exchange-rate risk. But these measures entail additional costs and do not provide complete protection.

Monetary factors in the form of nominal exchange-rate changes can thus have a major impact on enterprise investment and international competitiveness. The form and strength of this impact depends on a variety of factors operating through two channels: (i) marginal cost, where the impact partly depends on the firm's ratio of imported to domestically sourced production inputs, the share of financing denominated in foreign currency, and the impact of exchange-rate changes on domestic monetary conditions; and (ii) a possible mark-up of price over marginal cost. These factors can pull in opposite directions, and their relative strength can change with the length of time that elapses after the exchange-rate change. Moreover, they affect the instruments that firms can use to foster international cost competitiveness in a sustainable way (i.e. making productivity-enhancing investment) and to fend off temporarily adverse influences on their competitiveness (i.e. accepting a profit squeeze or resorting to wage suppression or labour shedding).

For example, firms can limit the adverse effects of currency appreciations on their international cost competitiveness temporarily, if they are able to follow a pricing-to-market strategy and absorb at least part of the exchange-rate change by a squeeze in profit margins. But trying to do so over a longer period of time risks compromising profit-related incentives for investment. On the other hand, firms may not be able to benefit from sharp real currency depreciations if the goods that they export, have a large import content, so that the net effect of the currency depreciation on the firms' international cost competitiveness is very small. More importantly, recent experience shows that adverse impacts of sharp real currency depreciations can compromise the ability of firms to expand production capacity or even maintain production at pre-depreciation levels. Indeed, the easing of capital controls, combined with the movement away from detailed documentation requirements for trade financing transactions, have seriously compromised the availability of trade finance from international sources in the aftermath of sharp currency depreciations. In addition, the tightening of domestic monetary conditions associated with the depreciation has made it difficult for domestic lenders to maintain their provision of short-term lending.

## **2. *Sharp exchange-rate changes and developing countries' export performance***

At the macroeconomic level, maintaining a stable exchange rate at an appropriate level is crucial for successful exporting and structural change towards high-productivity sectors. Discussions on the impact of exchange-rate changes on trade flows have frequently emphasized the effect of exchange-rate volatility on trade, or the contribution of currency depreciations to the removal of temporary imbalances in a country's current account. Typically, the focus has been on the impact of exchange-rate changes that are relatively small compared to the large gyrations in developing countries' real exchange rates that have frequently occurred since the early 1990s. This section, by contrast, focuses on the effects of large changes in real exchange rates, which are often associated with sharp and abrupt changes in the direction of short-term private international capital flows.

The large size of recent real exchange-rate changes brings an additional dimension to the just mentioned elasticity debate for at least two reasons. First, sharp exchange-rate changes in one economy can adversely affect the external trade position of other economies where the exchange rate remains relatively stable. For example, evidence from the Asian crisis points to competitive depreciations as an important form of contagion through trade linkages, as countries whose exporters compete directly with those in the crisis-affected country also face pressure to depreciate their currencies in order to avoid a loss in international competitiveness. This also means that exporters in the crisis-affected country do not experience the rise in demand for their products hoped for.

Second, the domestic impact of a sharp and abrupt exchange-rate depreciation is more complex than the adjustments resulting from small exchange-rate fluctuations, because sharp currency depreciations are typically associated with a drop in domestic economic activity and a need to cut imports of intermediate and capital goods. Combined with the sharp decline in the availability of trade finance, this tends to hamper the domestic supply response and undermines the ability of exporters to take advantage of their improved international cost competitiveness.

A detailed econometric estimation by the UNCTAD secretariat (*TDR 2004*: 113–124) highlighted the differences in the impact on developing country trade performance after “normal” and those following “major” real exchange-rate changes<sup>14</sup> over the period 1970–2002, i.e. the period that includes all major financial crises.

Table 2.2 shows that major currency depreciations boosted countries’ export performance only slightly more than more normal depreciations. Most importantly, contrary to depreciations of relatively small size, major depreciations did not lead to a statistically significant improvement in the trade balance. By contrast, changes in domestic income and world income had a sizeable and strongly significant impact on the ability of exporters to take advantage of increased international price competitiveness. Indeed, the results show that following major currency movements, a rise in the income share of exports was strongly and adversely affected by changes in domestic demand, while changes in domestic demand had no statistically significant impact on the income share of imports.<sup>15</sup> Thus currency depreciations and changes in domestic income and world income had a markedly different short-term impact on countries’ trade performance when they were associated with major exchange-rate changes rather than with comparatively smaller ones.

This finding is supported by the results in table 2.3, which show that comparatively small exchange-rate changes improved the trade balance in the short run, while there was no similar statistically significant effect of major exchange-rate changes. The results in table 2.2 also show that, contrary to their impact on the trade balance, major currency depreciations led to a statistically significant improvement of the current-account balance. This is likely to be related to the decline in the commissions and fees such as for letters of credit or lines of credit that accompanied the sharp decline in the access of firms to trade finance and working capital provided by foreign banks in the aftermath of financial crises. It may also reflect changes in the provision of services with a relatively high elasticity with respect to changes in exchange-rates and income.

The finding that, compared to depreciations of a more normal size, major exchange-rate depreciations neither give a sizeable additional boost to export performance nor result in proportionally larger improvements in

Table 2.2

**IMPACT OF CHANGES IN EXCHANGE RATES AND INCOME ON EXTERNAL PERFORMANCE: ESTIMATION RESULTS FOR DIFFERENT SIZES OF EXCHANGE-RATE CHANGE, 1971–2002**

	<i>Merchandise trade balance</i>	<i>Current account balance</i>	<i>Income share of exports</i>	<i>Income share of imports</i>	<i>Share in world manu- factured exports</i>
Major appreciations and depreciations					
Real effective exchange rate	-0.30	-0.08	-0.56*	-0.26	-0.18
Real domestic income	-2.27*	-1.79*	-1.77*	0.65	0.51
Real world income	3.91*	2.47**	5.75*	1.15	0.38
Other appreciations and depreciations					
Real effective exchange rate	-0.31*	-0.23*	-0.49*	-0.11	0.07***
Real domestic income	-0.88*	-0.83*	-0.05	0.86*	1.00*
Real world income	2.57*	1.09*	2.34*	-0.58**	1.80*
R-square	0.22	0.24	0.31	0.10	0.27
Total panel observations	677	585	679	684	679
Major appreciations					
Real effective exchange rate	-0.13	0.13	-0.44	-0.29	-0.27
Real domestic income	-1.54	-1.26	-0.72	0.86	1.01
Real world income	2.57	2.41	5.51**	2.69	1.22
Major depreciations					
Real effective exchange rate	-0.45	-0.41*	-0.86*	-0.46	-0.19
Real domestic income	-2.85*	-2.13*	-2.24*	0.78	0.41
Real world income	3.70**	0.57	4.23**	-0.37	0.16
Other appreciations and depreciations					
Real effective exchange rate	-0.31*	-0.22*	-0.49*	-0.10	0.07
Real domestic income	-0.89*	-0.84*	-0.06	0.86*	1.01*
Real world income	2.62*	1.16*	2.41*	-0.56***	1.79*
R-square	0.23	0.26	0.31	0.10	0.27
Total panel observations	677	585	679	684	679

**Source:** UNCTAD secretariat calculations, based on JP Morgan (2003) for exchange-rate data; IMF, *International Financial Statistics* database for current account data; and the UNCTAD database for trade and income data.

**Note:** \* Denotes significant at the 1 per cent level.  
 \*\* Denotes significant at the 5 per cent level.  
 \*\*\* Denotes significant at the 10 per cent level.

Table 2.3

**IMPACT OF CHANGES IN EXCHANGE RATES AND  
INCOME ON THE MERCHANDISE TRADE BALANCE:  
TIME PATH OF ADJUSTMENT, 1971–2002**

<i>Merchandise trade balance</i>	
Major appreciations and depreciations	
Real effective exchange rate	-0.10
One year lagged	-0.51
Two years lagged	0.32
Three years lagged	0.23
Four years lagged	0.20
Five years lagged	-0.89**
Real domestic income	-2.65*
Real world income	5.20*
Other appreciations and depreciations	
Real effective exchange rate	-0.26*
One year lagged	-0.26*
Two years lagged	0.22*
Three years lagged	0.13**
Four years lagged	0.11**
Five years lagged	-0.01
Real domestic income	-0.79*
Real world income	1.19*
R-square	0.31
Total panel observations	547

**Source:** See table 2.2.

**Note:** \* Denotes significant at the 1 per cent level.

\*\* Denotes significant at the 5 per cent level.

\*\*\* Denotes significant at the 10 per cent level.

the trade balance is likely to reflect also the impact of at least one other factor discussed earlier. The observed worsening of firms' access to trade finance from both international and domestic sources in the aftermath of major currency depreciations makes it difficult for those firms to expand or even merely maintain activity levels. This seriously inhibits their supply response to benefit from lower dollar-denominated export prices.



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## C. Policy adjustment with open capital accounts

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For policy makers in developing countries, the fact that exchange-rate changes can influence the overall competitiveness of a country and have the potential to directly improve the overall trade performance of the majority of their firms and the balance of payments is a promising prospect. On the other hand, the effectiveness of the exchange rate as an economic policy tool is constrained by the policy of other countries (the exchange rate of any country is, by definition, a multilateral phenomenon), as well as by the influence of the global capital market. The following section examines how speculative short-term capital flows and resulting exchange-rate misalignments are induced by short-term interest rate differentials and floating currencies in open capital markets.

### 1. *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 raising 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 responsible 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

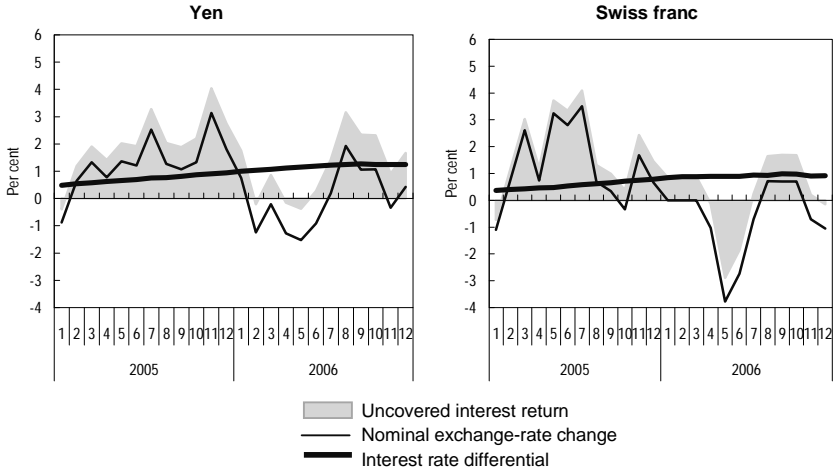
destabilizing speculative capital-account operations; it displays numerous similarities with the mechanisms that caused financial fragility in many emerging markets, leading thereafter to currency and financial crises in the mid-1990s. The more general mechanisms of destabilizing speculation, on the 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 risk 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 in the first quarter of 2006 (and similarly in the first quarter of 2008) 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 2.1 shows past carry trade potentials driven by the nominal exchange-rate dynamics and interest rate differentials between the dollar

**Figure 2.1**  
**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 indicates an appreciation of the dollar vis-à-vis the yen (left figure) or the Swiss franc (right figure).

and the yen (left chart) and between the dollar and Swiss franc (right chart). The thick line represents the 3-month interest rate differential between the dollar- and yen- or Swiss franc-denominated assets; the thin 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).

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 those periods 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 2.2, 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 solid 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 (thin line in the right charts). An index of the real exchange rate is plotted on the left panel (dashed line) and measured on the right vertical axis.<sup>16</sup> 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 2.1.

Figure 2.2 shows for four regional country groups (for country-specific evidence, see *TDR 2007*, figures 1.4 and 1.A1) how alternative exchange-rate regimes and different monetary policies generate varying degrees of profit opportunities for international speculators; it also shows how much real appreciation (with a loss of overall competitiveness) can result from speculation that is driven by interest rate differentials.

The group of Asian developing countries includes China that has adopted a pegged exchange rate and ten other economies that have followed managed or independent floating. Experience of the group as a whole has been characterized by moderate inflation and low interest rates, which has

stabilized expectations of investors in fixed capital and limited short-term speculative capital inflows. Regarding China, its exchange rate, capital market and monetary regimes have been very stable over a long period of time. A pegged exchange rate, low inflation and low interest rates have led to expectations of stability by investors in fixed capital, and have not attracted short-term carry-trade speculators. Low nominal and real interest rates have caused short-term speculative profit returns to be nil or even negative, thereby discouraging speculative capital inflows 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. The other economies have recently experienced exchange-rate volatility and real appreciation.

The experience of Mexico and Brazil (and to a lesser extent of Argentina) regarding the evolution of inflation and interest rates, as well as of nominal and real exchange rates, has dominated the picture of the group of Latin American developing countries shown in figure 2.2. Prior to the 1999-crisis, the situation in Brazil was characterized by an overvalued real exchange rate and a large differential between domestic and international interest rates (aimed at maintaining capital inflows). During the same period, Mexico also had high domestic interest rates, while relatively high inflation rates were appreciating the real exchange rate. Brazil's 1999-crisis forced a large nominal depreciation of the real and led to an interest rate hike that also affected interest rates in Mexico and Argentina. After the 1999-crisis, Brazil adopted a floating exchange-rate regime and implemented an inflation-targeting monetary policy (Barbosa, 2006). The 2001-crisis in Argentina and the 2002-depreciation of the Brazilian real triggered a surge in inflation rates followed by a rise in interest rates. While interest rate differentials aimed at curbing inflation have been significantly reduced in Mexico, Brazil is still offering considerable potential gains for short-term speculation. Argentina, on the other hand, was able to contain real appreciation and succeeded in moderating inflation although preserving low interest rates.

South Africa dominates the picture for the group of African developing countries. Following the recent adoption of inflation targeting, South Africa

Figure 2.2

**UNCOVERED INTEREST RETURNS, EXCHANGE-RATE CHANGES, INFLATION AND INTEREST RATE DIFFERENTIALS, SELECTED REGIONS, 1996–2006**

(Weighted averages)

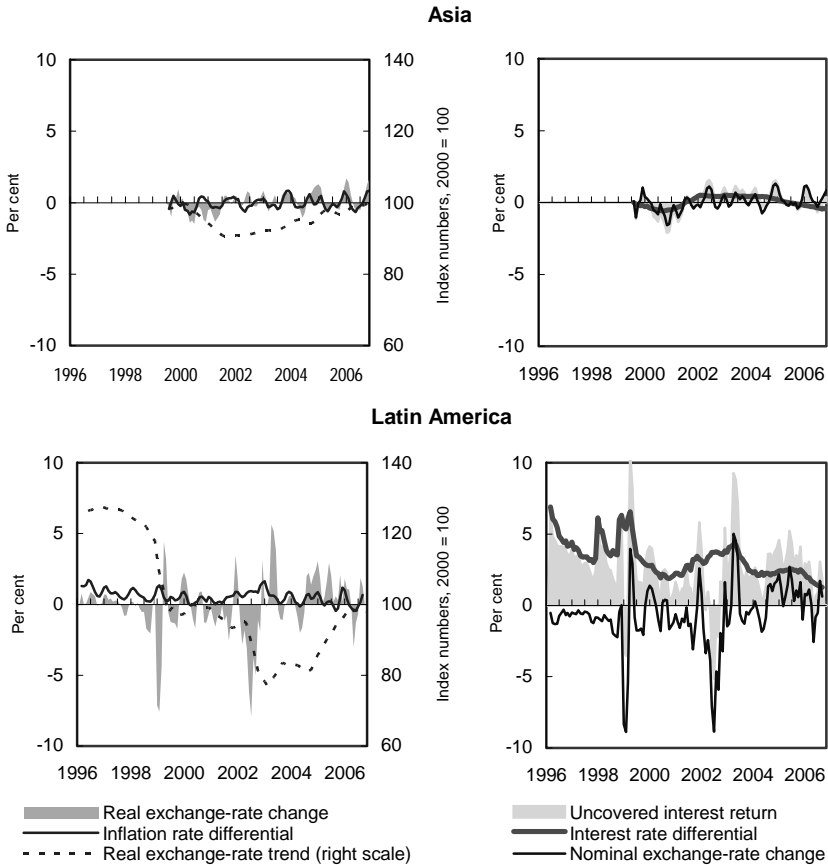
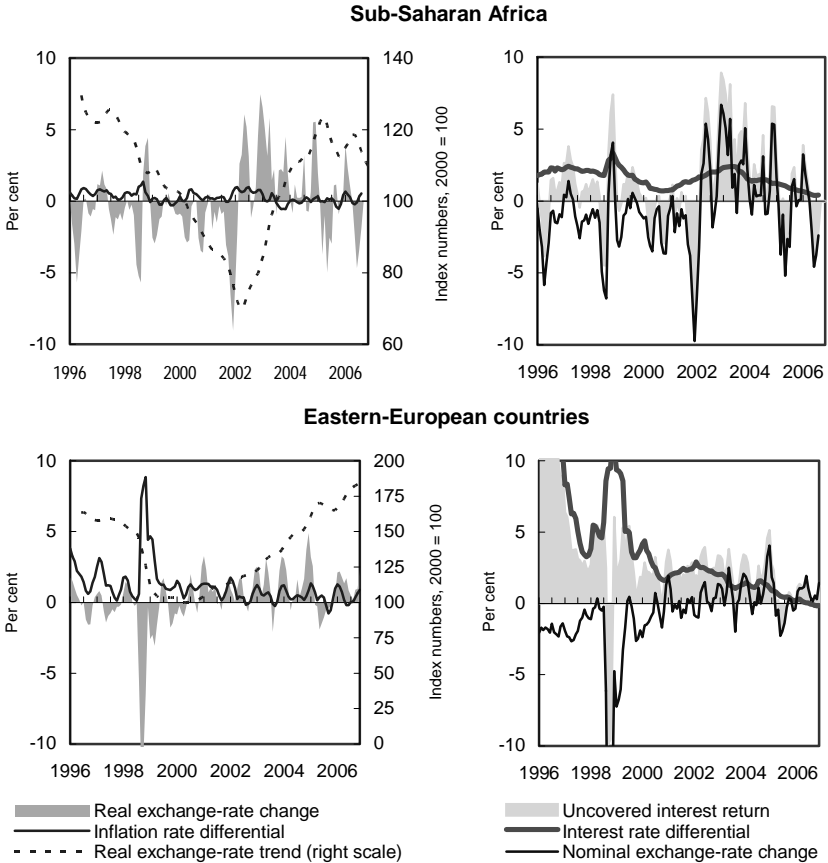




Figure 2.2 (concluded)

**UNCOVERED INTEREST RETURNS, EXCHANGE-RATE CHANGES, INFLATION AND INTEREST RATE DIFFERENTIALS, SELECTED REGIONS, 1996–2006**

(Weighted averages)



**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. **Asia:** China, Hong Kong (China), India, Indonesia, the Republic of Korea, Malaysia, Pakistan, the Philippines, Singapore, Taiwan Province of China and Thailand; **Latin America:** Argentina, Bolivia, Brazil, Colombia, Dominica, Mexico, Uruguay and Venezuela (Bolivarian Republic of); **Eastern European countries:** Czech Republic, Hungary, Lithuania, Poland, Russian Federation and Bulgaria; and **sub-Saharan Africa:** Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Kenya, Mali, Mauritius, Niger, Senegal and South Africa.

has experienced large nominal and real appreciation that have undermined its competitive position and led to a large current account deficit. Before the 2001 exchange-rate fall, frequent depreciations had preserved the real exchange rate at rather undervalued levels. Interest rate differentials have declined after the upswing of 2001, but significant outflows in 2005 and 2006 have led to large depreciations followed by sharp appreciation and a reversal of portfolio flows.

The picture for Eastern Europe, dominated by that for the Russian Federation, has been characterized by large interest rate differentials, aimed at controlling inflation and preserving capital inflows or avoiding outflows. The recent decline in the interest rates has not been accompanied by a reduction in the inflation rates, nor substantial depreciations. The real exchange rate has been persistently rising across the economies in the group.

To summarize, managed depreciation or pegging of exchange rates, associated with large interest rate and inflation rate differentials, have in many cases led to real appreciation and the loss of competitiveness, and have offered opportunities for speculation. In the 1990s, this occurred to a large extent in pre-crisis Brazil, Thailand, the Republic of Korea and the Russian Federation. 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, these opportunities remain a major source of instability and risk. Relatively high 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 domestic capital formation.

## **2. *Changing opportunities for speculation in emerging market economies***

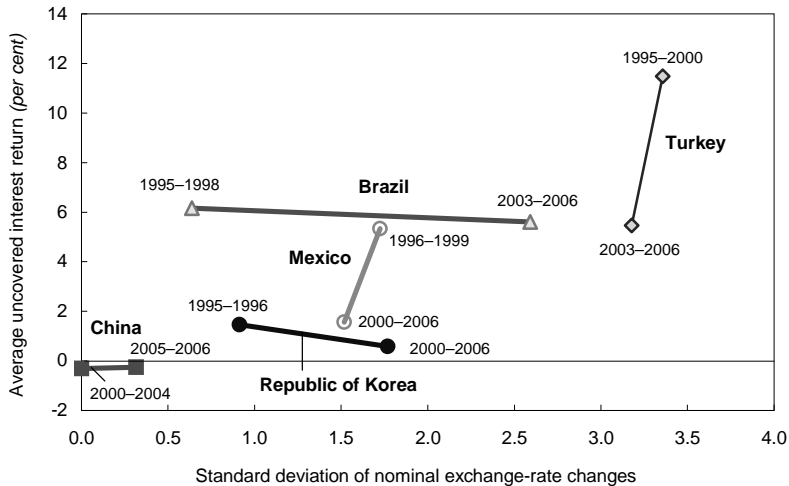
Carry trade, as any other form of speculation on international interest rate differentials that is not covered in the forward currency market, involves a currency risk. Speculative capital flows typically respond to short-term current and expected monetary variables, such as the interest rate, the exchange 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 amount of financing available to investors is 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).<sup>17</sup> Traditional macroeconomic analysis would assume that currency volatility tends to reduce any form of speculation. However, even allowing for a certain degree

Figure 2.3

**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.

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 necessarily 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 can be sufficient to generate them.

Figure 2.3 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 speculative short-term capital inflows that would have followed the logic of interest rate arbitrage.

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 interest 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.

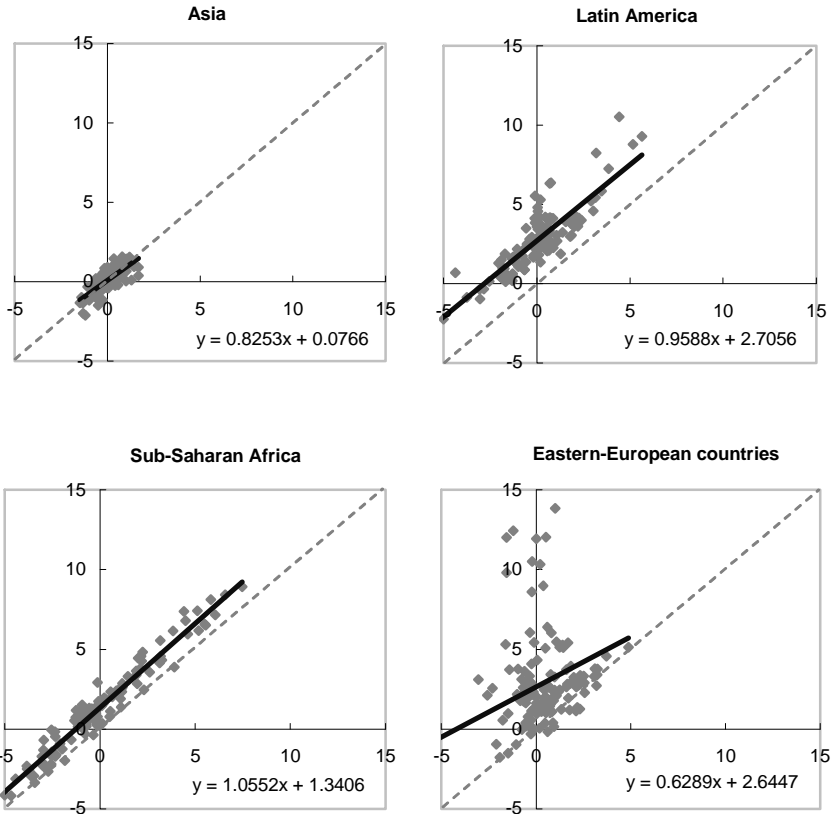
### **3. *Speculative capital flows and real effects***

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 2.4 shows the UIR (vertical axis) and real exchange-rate appreciation (RERA, horizontal axis) for selected regions. 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

Figure 2.4

REAL EXCHANGE-RATE CHANGES AND UNCOVERED INTEREST RETURNS IN SELECTED REGIONS, 1996–2006

(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.

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.

A tendency of the observation points in this figure (each representing a three-month investment) 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 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 2.1 for a more detailed interpretation of these coefficients).

Regions whose data points are 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 Asia and sub-Saharan Africa. As regional groups, Latin America, sub-Saharan Africa, and Eastern Europe have experienced volatile real exchange rates and uncovered interest returns.

Regarding specific country experiences, the change in monetary regimes from soft peg to float in Thailand and the Republic of Korea, following the Asian financial crisis in 1997–1998, was accompanied by considerable exchange-rate volatility, but with a tendency towards real appreciation. In Indonesia, increased exchange-rate volatility went hand in hand with an even larger appreciation and no significant reduction in interest rates. Again, China displays a 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 investment and the creation of fixed capital.

Brazil, Hungary, Mexico, and South Africa have recently adopted inflation targeting, i.e. a monetary regime that typically requires a free

**Box 2.1****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



**Box 2.1 (continued)****UNCOVERED INTEREST PARITY**

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  $\omega$ ,  $\rho$ ,  $\delta$ ,  $\pi$ , and  $\pi^*$  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

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

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

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,  $\omega$ , and the real appreciation,  $\rho$ , 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  $(\rho, \omega)$  space (see figure 2.4).

The relation between points in the  $(\rho, \omega)$  space can be easily captured by identifying the parameters:  $\alpha$  and  $\beta$  obtained by regressing the relation

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

**Box 2.1 (concluded)****UNCOVERED INTEREST PARITY**

which implies

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

with  $\beta$  capturing the comovements of  $\pi - \pi^*$ ,  $i - i^*$  and  $\delta$ , and with  $\alpha$  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,  $\rho$ , and the returns,  $\omega$ , 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  $\gamma$  is greater the larger the values of  $\rho$  and  $\omega$ .

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  $\beta$ , for a given exchange rate). The larger  $\beta$ , 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.

float of the currency and control of inflation rates through interest rates. Although the post-crisis regime marked deep structural changes for Brazil, Hungary, and Mexico, 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, and South Africa. Their high real interest rates, consistently larger than the United States benchmark, constrain capital accumulation and may generate inflationary pressures by reducing capacity growth in the longer run.

#### **4. *The potential of un-coordinated national exchange-rate policies to control external accounts***

Box 2.1 in the preceding section has shown that if the nominal short-term interest rate in a financially open emerging-market economy exceeds that in a developed country by more than the growth differential, the nominal exchange rate of the former should depreciate at a (annual) rate that equals the difference in (annual) interest rates. If this is not the case, the situation is not sustainable, as either the high interest rate or the overvalued exchange rate hampers sustainable economic development in the emerging market economy.

Hence, combining floating of the currency with restrictive domestic monetary policy to bring down inflation will destabilize the external account. Speculation on uncovered interest rate parities will yield high returns to arbitraging international portfolio investors, as nominal and real interest rates in the developing economies are generally higher than in the leading industrialized economies. The currencies of the high-inflation countries will tend to appreciate, thereby, temporarily, even increasing the incentive for foreign investors to buy domestic assets and the incentive of domestic borrowers to borrow abroad.

Overall, the dilemma for developing-country policymakers of a situation in which international investors earn high rates of return in their countries, despite falling domestic real income, profits and employment, cannot be resolved under conditions of free capital flows. Developing-

country policymakers are usually unable to reduce interest rates to stop the speculative capital inflow, because doing so would endanger the credibility of their monetary policy domestically. The political will to achieve economic stability is reflected in the decision to keep nominal interest rates high. How long an external economic imbalance following an exchange-rate peg or an appreciation can be sustained is an open question. With growing visible external imbalances the developing country's exchange-rate policy will begin to lose credibility in markets. Once investors are convinced that the anchoring country will not be able to manage slowing down the growth of its external debt smoothly, confidence will deteriorate. This will lead to renewed crisis, a reduction of reserves and eventually a depreciation of the country's exchange rate.

In any case, exchange-rate changes are necessary to compensate for the opening scissor blades of the price and cost developments between a high-inflation and a low-inflation country. As long as developing countries are not able to perfectly converge in nominal terms with the developed countries, devaluations are unavoidable in order to preserve the competitiveness of the high-inflation countries. However, exchange-rate changes, and in particular, real exchange-rate changes, that determine the competitiveness of the whole economy, cannot be left to the market. Given the arbitrage opportunities between high- and low-inflation countries, a rule of competitive neutrality of the exchange rate, like the purchasing power parity (PPP) rule, has to be enforced by governments and/or central banks. Ideally, such a rule should be the result of multilateral agreements, as exchange-rate changes always have multilateral repercussions. But if the international community is not able to agree on rules to avoid competitive devaluations and huge destabilizing shocks, countries will continue to manage the floating of their currencies unilaterally.

Managed floating, however, faces an adding-up problem on the global scale. Not all countries can simultaneously manage the movements of their exchange rate and achieve their targeted rates. The exchange rate, by definition, is a multilateral phenomenon, and attempts by many countries to keep their currencies at an undervalued rate may end up in a race to the bottom – or in competitive devaluations – that would be as harmful for the world economy as in the 1930s. Moreover, given the size of international short-term capital

flows and the inherent volatility of these flows, only those developing countries that are big and competitive enough to withstand strong and sustained attempts of the international financial markets to move the exchange rate in a certain direction will be able to manage the floating successfully. A small and open developing economy will hardly be able to continue fighting a strong tendency to appreciate over many years or even decades.

## **5. A multilateral solution**

Multilateral or even global arrangements are clearly suited best to maintain global monetary and financial stability. However, the rapid pace of globalisation in monetary and financial relations has not been accompanied by an equally rapid change in multilateral monetary and financial rules and disciplines. The Bretton Woods institutions have progressively assumed different mandates and have extended their functions to areas far from those that they had been given originally (such as structural reforms covering a wide range of economic and social matters in developing countries and in economies in transition). Yet they appear to exercise little control over key international financial problems like exchange-rate volatility, huge and prolonged balance-of-payments imbalances, the dominance of short-term financial flows over long-term ones, and recurrent financial crises. Nor do they seem to possess the appropriate instruments for responding to these problems.

Above all, the existing global economic governance system lacks institutional arrangements that could exercise multilateral discipline on exchange rates. Until the early 1970s, the power of financial markets to generate unexpected and erratic movements in exchange rates was limited in part by the low value of financial market transactions relative both to trade transactions and to the amount of foreign exchange reserves. The power of financial markets was also constrained by capital controls and the obligation, under the Bretton Woods system, of central banks to intervene in foreign-exchange markets in order to maintain exchange-rate stability. The system restricted the kind of short-term capital flows that were motivated by interest arbitrage and that had proven so damaging in the interwar period. By defining narrow exchange-rate bands, the Bretton

Woods system also limited the ability of governments to manipulate the exchange rates of their currencies. This was intended to prevent beggar-thy-neighbour policies based on competitive depreciation, the lack of such prevention having been among the most damaging policy failures of the interwar period.

These institutional arrangements allowed the Bretton Woods system to ensure a balance between national policy autonomy on the one hand and multilateral disciplines on the other. Sacrificing formal monetary autonomy was rewarded by stability in the financial markets and better foresight in international trade and in related decisions concerning investment in fixed capital.

However, the Articles of Agreement in the International Monetary Fund (IMF) provided for changes in par values “to correct, or prevent the emergence of, a fundamental disequilibrium” (Article IV and Schedule C of the IMF Articles of Agreement). In many cases this adjustment was supported by the provision of financing from IMF resources to enable countries “to correct maladjustments in their balance-of-payments without resorting to measures destructive of national or international prosperity” (Article I of the IMF Articles of Agreement). At the same time, the conditionalities associated with this financing entailed macroeconomic adjustments in borrowing countries to support the reduction of external imbalances, with the aim of protecting both the financial integrity of the Fund and the revolving nature of its resources.

The balance between financing and adjustment in crisis situations has gradually been lost since the termination of the Bretton Woods exchange-rate system. Instead of providing adequate liquidity to allow countries to weather payments difficulties, the IMF started to impose extensive adjustments in macroeconomic and even in structural policies. Indeed, the Fund sought to impose the kind of policies that the architects of the post-World War II international monetary system had wanted to avoid on countries facing payments difficulties – that is, adjustment through austerity – irrespective of the causes of the payments difficulties. These difficulties might result from domestic factors such as a loss of the overall competitiveness of the economy, excessive domestic spending or distortions in the price structure; or from external disturbances such as terms-of-trade shocks, hikes in international

interest rates, trade and exchange-rate measures introduced by another country, or the volatility of capital flows and international speculation.<sup>18</sup>

Today the IMF may intervene in a country's exchange-rate policy only if that country asks for financial support from the Fund and thus becomes subject to IMF conditionality. Hence the IMF has no grip on possible exchange-rate misalignments in an economy that runs a balance-of-payments surplus, or in deficit countries that still have access to borrowing in international financial markets or issue a currency that other market participants are willing to continue holding in their portfolios, as in the case of the United States. Therefore, negotiations on exchange rates among the most important currencies, when they occur, are held outside the IMF, mainly at the G-7 meetings or in bilateral talks among the most important players.

This highlights a basic asymmetry and shortcoming in the current international financial system: the institution that is in charge of promoting exchange-rate stability and of avoiding excessive and prolonged payments disequilibria is unable to impose meaningful disciplines on the policies of those economies that run the most significant external imbalances and whose exchange-rate volatility has the most significant negative impact on the international economy. The Fund's policy oversight is confined primarily to its poorest members, who need to draw on its resources because of their lack of access to private sources of finance and, occasionally, to emerging-market economies experiencing currency and financial crises. As a result, the bulk of the adjustment burden in case of external imbalances is concentrated in a group of developing and transition economies despite the fact that the source of such imbalances may be found in the developed world.

In fact, in a financially highly-integrated world the Fund is unable to tackle one of the main sources of current-account imbalances in developing countries, namely, exchange-rate misalignments that are due mainly to volatile, and often speculative, short-term capital flows. As shown above, exchange-rate gyrations are not always driven by policy errors in the receiving countries. Even countries following orthodox monetary policies of price stabilization can be subject to strong overshooting of their exchange rates, leading first to over- and then to undervaluation. Capital flows, which have come to have a much stronger impact on nominal exchange rates than trade

flows, are closely related to short-term financial conditions. For example, speculation that aims at exploiting short-term interest rate differentials for arbitrage profit can eventually lead to pressure on the exchange rate and become destabilising even if the countries involved have only slightly diverging inflation rates.

A multilateral approach in the form of a code of conduct could address the shortcomings of current international monetary and financial arrangements in an effective way. Such a code of conduct, reflecting a new spirit of multilateralism in global economic governance, 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 deviating from the fundamentals (inflation differentials) affect international trade in exactly the same way as changes in tariffs and export bounties do. Consequently, such real exchange-rate changes have to be subject to multilateral oversight and negotiations. The reasons for the deviation from the fundamentals and the necessary dimension of the deviation have to be identified by an international institution and have to be enforced by a multilateral decision-making body. Only if such rules apply can all trading parties avoid unjustified overall losses or gains of competitiveness and developing countries systematically avoid the trap of overvaluation that has been one of the most important impediments to prosperity in the past.

The exchange rate of any country is, by definition, a multilateral phenomenon, and any rate change in open economies produces externalities and multilateral repercussions. That is why the idea of a cooperative global monetary system is as compelling as the idea of a multilateral trading regime. In the same way as intended by multilateral trade rules, a well-designed global financial system has to create equal conditions for all parties involved and help to avoid unfair competition. 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.

In the absence of a multilateral system, developing countries must be allowed to manage exchange rates and capital flows at the national or regional levels, as discussed below.



### III. REGIONAL COOPERATION

The first part of this publication has focussed on policies at the national level and measures at the multilateral level needed to ensure coherence between financial and trade matters and translate international economic integration by developing countries into sustained economic growth. Regional cooperation among developing countries carries additional potential in particular in those areas where there currently is little hope for appropriate action at the multilateral level.<sup>19</sup> This second part of the publication addresses areas where developing countries can build on their common and complementary interests with a view to strengthening their efforts to make globalization an inclusive process.

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 investment, 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, 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.<sup>20</sup> *TDR 2006* 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. What is examined here is 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 system.<sup>21</sup> From this perspective, regionalization is a “stumbling block”, worse still, it is an “insidious” or even “degenerate” trend.<sup>22</sup> 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.<sup>23</sup> 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.

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## A. The limitations of conventional thinking

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### 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.<sup>24</sup> 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.<sup>25</sup>

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.<sup>26</sup> 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.<sup>27</sup>

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 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 insistence 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.<sup>28</sup>

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 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.<sup>29</sup>

## **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 section C below), 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.<sup>30</sup> 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 fixed, 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.<sup>31</sup> 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).



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,<sup>32</sup> 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).

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## **B. Regionalization and policy cooperation**

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### **1. *Industrialization and the integration challenge***

The same regions that dominate world trade also dominate world industry: North America, the European Union (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 3.1). 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.<sup>33</sup> 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

**Table 3.1**  
**MANUFACTURING VALUE ADDED, TOTAL TRADE AND TRADE IN**  
**MANUFACTURES, EU-15, NAFTA AND EAST ASIA, 1991–2005**  
*(Per cent)*

	1991	1995	2000	2005
<i>Share in world manufacturing value added</i>				
EU-15	29.8	27.6	23.6	27.6 <sup>a</sup>
NAFTA	24.9	24.9	30.5	25.4
East Asia <sup>b</sup>	25.3	29.5	29.4	29.7
Total	80.0	82.1	83.5	82.7
<i>Share of total trade in world trade</i>				
EU-15	43.2	39.4	35.6	35.2
NAFTA	17.9	18.0	22.3	17.8
East Asia <sup>b</sup>	16.6	18.3	18.1	19.1
Total	77.7	75.8	75.9	72.2
<i>Share of region's manufactured trade in world manufactured trade</i>				
EU-15 <sup>c</sup>	..	39.9	36.0	36.4
NAFTA	..	19.1	24.0	18.8
East Asia <sup>b</sup>	..	20.5	20.4	22.2
Total	..	79.5	80.4	77.4
<i>Share of intraregional trade in manufactures in world trade in manufactures</i>				
EU-15 <sup>c</sup>	..	24.9	21.2	21.2
NAFTA	..	7.9	11.1	7.8
East Asia <sup>b</sup>	..	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.

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.<sup>34</sup> 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).<sup>35</sup> 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 internal and external integration.<sup>36</sup> 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.<sup>37</sup> 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***

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.<sup>38</sup> 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 section C below).

The development literature has identified other constraints and gaps that can disrupt cumulative 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 section D below).

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 microeconomic 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 section D below).

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### **C. Regional cooperation and trade integration among developing countries**

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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), as discussed in *TDR 2007*: 53–85. 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.

This section first provides, in sub-section 1, 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. Sub-sections 2 and 3 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. Sub-section 4 concludes, highlighting South-South regional trade cooperation as a complementary vehicle for moving towards greater integration into the world economy.

### **1. *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

Table 3.2

**MAIN CHARACTERISTICS OF DIFFERENT TYPES OF TRADE  
INTEGRATION ARRANGEMENTS**

	<i>Reduction of tariffs in intra- regional trade</i>	<i>Elimination of tariffs in intra- regional trade</i>	<i>Common tariffs for the rest of the world</i>	<i>Free factor mobility</i>	<i>Harmoni- zation 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.

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 3.2).

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 section D below). 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.

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.

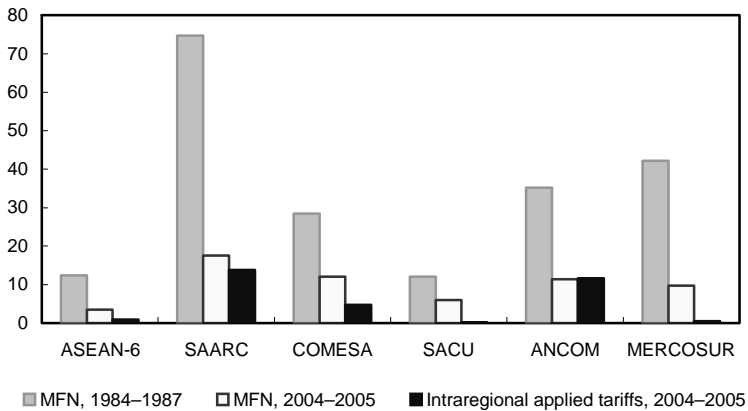
Early regional cooperation agreements, which were concluded mainly by countries at similar levels of development, shared common and closely interlinked political and economic objectives. These agreements typically had ambitious aims with regard to the degree of integration, often going well beyond those 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).<sup>39</sup> 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. 3.1). Moreover, the conclusion of a number of North-South trade agreements has further weakened the potential benefits of regional preferences (see *TDR 2007*: 53–65).

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 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 remain 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.<sup>40</sup> 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.

**Figure 3.1**  
**TRADE-WEIGHTED TARIFFS IN SELECTED REGIONAL AGREEMENTS**  
 (Per cent)



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

**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.

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 periods 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 the North American Free Trade Agreement (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 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 transnational corporations. 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 outward FDI.<sup>41</sup> 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 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.<sup>42</sup> 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.<sup>43</sup> 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 production and trading region until the middle of the 1990s. The largest proportion of manufactured goods, particularly information technology (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.

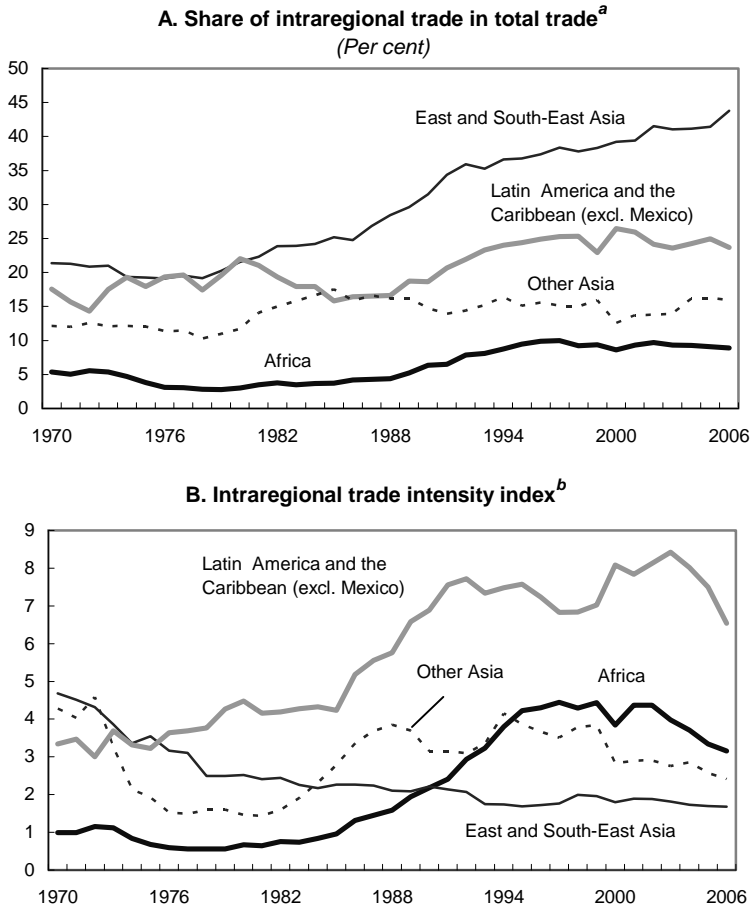
## **2. Measures of regional trade integration**

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. 3.2A), 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. 3.2B).

Figure 3.2

**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.

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 globalization 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).

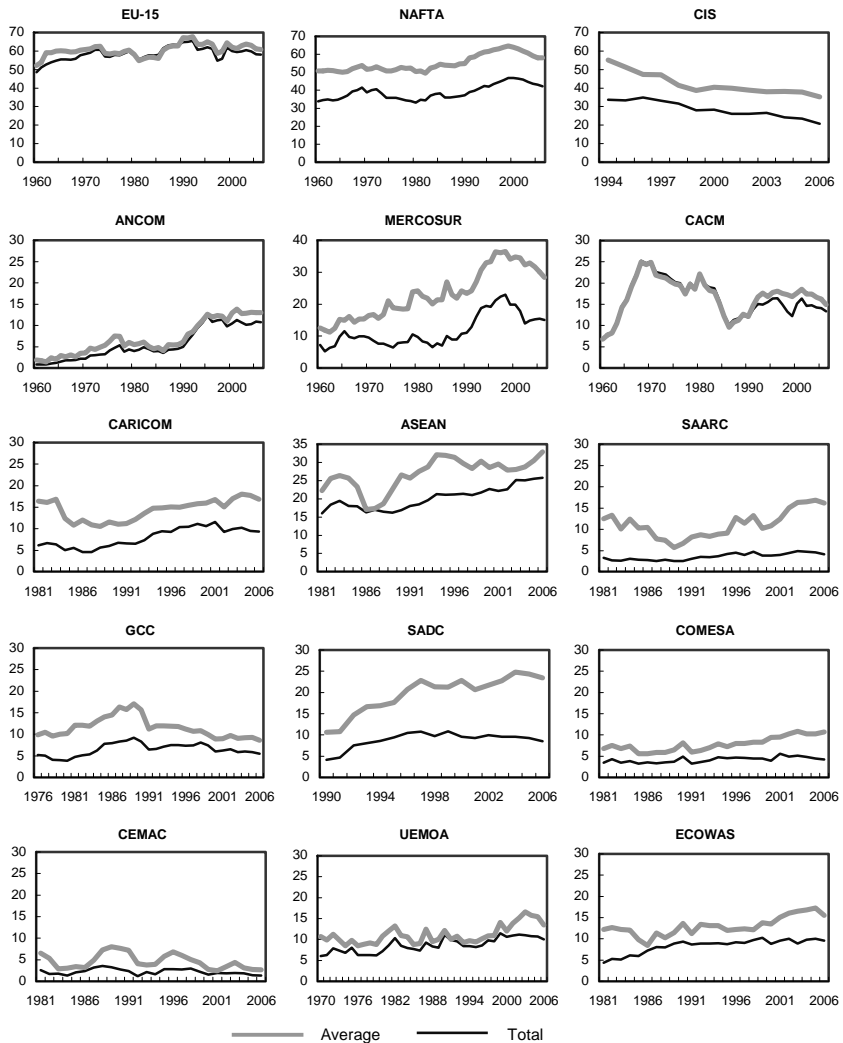
The volume of intraregional trade varies considerably among different formal regional blocs, corresponding roughly to the stage of development of their member States in terms of per capita income and degree of industrialization. For instance, intraregional trade is very significant within the EU and 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 3.3 shows the evolution of intraregional trade in selected regional agreements,<sup>44</sup> 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*

Figure 3.3

**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 in function of availability of comparable data.

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 the Southern Common Market (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 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.

### **3. 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, 1996; 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 (Rodríguez-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 (*TDR 2003*, chap. V).

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 locations, 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 science 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.

Empirical evidence (*TDR 2007: 103–110*) shows that 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 composition, 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 regional trade agreements (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.

#### **4. *The potential role of South-South regional trade agreements***

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 conditions 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 3.3). It appears that, in general, countries at higher levels of industrial development and diversification, such as South Africa in SADC, Côte d'Ivoire in the West African Economic and Monetary Union (UEMOA), Kenya in the Common Market for Eastern and Southern Africa (COMESA), India in SAARC, Brazil in MERCOSUR, Colombia in the Andean Community of Nations (ANCOM) and the Russian Federation in the CIS, achieved surpluses in their trade with their regional partners, while the less advanced (and frequently



**Table 3.3**  
**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
<b>UEMOA</b>					
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
<b>SADC</b>					
South Africa	3 022	1.7	Zambia	-557	-10.1
			Mozambique	-533	-10.3
			Zimbabwe	-474	-11.2
			Others	-1 600	-3.3
<b>COMESA</b>					
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
<b>CACM</b>					
Costa Rica	432	2.4	Honduras	-408	-5.6
Guatemala	355	1.4	Nicaragua	-264	-6.0
			El Salvador	-102	-0.7
<b>MERCOSUR</b>					
Brazil	1 308	0.2	Paraguay	-643	-9.4
			Uruguay	-597	-3.8
			Argentina	-225	-0.1
<b>ANCOM</b>					
Colombia	1 237	1.3	Peru	-806	-1.2
Bolivia	174	2.0	Ecuador	-728	-2.6
			Venezuela (Bolivarian Rep. of)	-331	-0.3
<b>SAARC</b>					
India	2 845	0.4	Bangladesh	-1 518	-2.7
			Sri Lanka	-933	-4.7
			Others	-401	-0.4
<b>CIS</b>					
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.

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 gross domestic product (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 in an extremely deeply integrated manner 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. The Southern African Customs Union (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 extraregional 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 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.<sup>45</sup> 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

**Box 3.1****THE MERCOSUR STRUCTURAL CONVERGENCE FUND**

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).

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 intraregional 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 3.1).<sup>46</sup>

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 in *TDR 2007*. For example, 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 developed 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 members 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.

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#### **D. Regional financial and monetary cooperation**

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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 as much by the globalization of finance as 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 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). These authors argue that 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 had grown, because conditionality had gone beyond what could have been justified by the need to safeguard the resources of the IMF, thereby strongly impinging on the sovereignty of the borrowing countries, and because it had not differentiated 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. The growing volume of intraregional 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.<sup>47</sup> 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 capital 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 commercial 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 channelling 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 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 capital 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.

This section examines three major areas in which regional monetary and financial cooperation may help in dealing with international financial system shortcomings. Sub-section 1 discusses developing country experience in regional payment facilities and short-term financing. While these mechanisms are primarily related to trade facilitation, they may evolve towards more ambitious regional financial arrangements and provide a complement – or, in some circumstances, a substitute – to multilateral sources of balance-of-payments financing. Sub-section 2 addresses the role

of regional cooperation in the provision of development financing, particularly through regional and subregional development banks. It also examines the initiative for creating regional bond markets, which could become a stable regional source of financing for companies, banks and public entities, while at the same time offering regional investors, including pension funds, options for wealth accumulation. Sub-section 3 examines lessons from currency unions in Africa, while sub-section 4 outlines the main lessons to be learned from the European experience for monetary cooperation and monetary policy in developing countries. Finally, sub-section 5 draws some conclusions for the global and regional monetary institutions.

### **1. *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.

Some of the mechanisms of mutual credit that were created by developing countries during the 1960s and 1970s 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 1980s 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 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).<sup>48</sup> For the respective currencies, the London interbank offered rate (LIBOR) determines the interest required for swap transactions. Any request for financial support has to be put to the expanded ASEAN Swap Arrangement, 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 3.4). 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 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 2007<sup>49</sup>).

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

**Table 3.4**  
**BILATERAL SWAP ARRANGEMENTS UNDER THE CHIANG MAI INITIATIVE**  
*(Billions of dollars)*

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

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

<sup>a</sup> Local currency swap between the Japanese yen and the Chinese yuan.

<sup>b</sup> Local currency swap between the Chinese yuan and the Korean won.

<sup>c</sup> 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.

<sup>d</sup> Local currency swap between the Chinese yuan and the Philippine peso.

<sup>e</sup> Local currency swap between the Japanese yen and the Korean won.

<sup>f</sup> 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).

Reserve Fund (FLAR) and enlargement of its membership.<sup>50</sup> 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.<sup>51</sup>

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 Latin American Integration Association (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 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.

## **2. *Regional cooperation for development financing***

### *(a) 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 process. 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 (Culpepper, 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 3.5).

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 credit rating 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 countries<sup>52</sup> 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 \$3,170 million in 2006; in the same period, credits approved by



CAF increased from \$3,300 million to \$5,520 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 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

**Table 3.5**  
**REGIONAL DEVELOPMENT BANKS OUTSTANDING LOANS:**  
**TOTAL AMOUNT, DISTRIBUTION AND DEBT RATINGS, 2005–2006**

Institution/region	Loans <sup>a</sup>		Destination by regions <sup>b</sup>		Distribution by main sectors <sup>b</sup>		Debt ratings <sup>c</sup>	
	(\$ million)	(Per cent)	(Per cent)	(Per cent)	(Per cent)	(Per cent)	Long-term	Short-term
<b>Latin America and the Caribbean</b>								
Inter-American Development Bank	53 047		South America	67.6	Energy	13.8	AAA	A1+
incl. Fund for Special Operations (IDB)			Central America	24.9	Social investment	13.7		
			Caribbean	5.5	Transport and communication	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 communication	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 communication	37.4	A+	A1
			Other America and regional operations	10.9	Social and infrastructure	35.1		
					Electricity, gas and water	11.4		
<b>Africa</b>								
African Development Bank Group <sup>d</sup>	19 118		Sub-Saharan Africa	64.2	Agriculture and rural devel.	18.1	AAA	A1+
			North Africa	32.7	Transport	16.5		
			Regional operations	3.1	Multisector	15.2		
Ecowas Bank for Investment and Development (EBID Group)	54		West Africa	100.0	Infrastructure	65.6	..	..
					Agriculture and rural devel.	15.8		
					Energy	10.1		

Eastern and Southern African Trade and Development Bank (PTA Bank)	228	Eastern and Southern Africa	100.0	Manufacturing Infrastructure Agribusiness	25.9 22.1 15.0	..	..
<b>Asia</b>							
Asian Development Bank (ADB) and Asian Development Fund (ADF)	47 700	East and South-East Asia Central and South Asia Oceania Regional operations	57.0 41.5 1.4 0.1	Transport and communication Energy Agriculture and natural resources	23.1 20.1 13.4	AAA	A1+
<b>Arab and Islamic institutions</b>							
Arab Bank for Economic Development in Africa (ABEDA)	653	Sub-Saharan Africa Regional operations	99.9 0.1	Infrastructure Agriculture and rural devel. Energy	52.2 27.0 6.9	..	..
Arab Fund for Economic and Social Development (AFESD)	6 313	West Asia North Africa Sub-Saharan Africa	50.4 47.8 1.8	Energy and electricity Transport and communication Agriculture and rural devel.	31.5 22.2 18.0	..	..
Arab Monetary Fund (AMF)	1 086	North Africa West Asia Sub-Saharan Africa	72.2 19.7 8.1	Balance-of-payments loans Structural adjustments Trade facilitation	74.2 19.8 6.0	..	..
Islamic Development Bank Group (ISDB)	6 748	West Asia Other Asia North Africa Sub-Saharan Africa Rest of the World <sup>e</sup>	36.3 29.9 23.6 8.2 2.0	Public utilities Social sector Transport and communication	26.0 22.7 18.4	AAA	A1+

**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](http://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.

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 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)<sup>53</sup> which, besides setting special financial conditions for their imports of the Bolivarian Republic of Venezuela's oil, has created a number of joint-venture enterprises in the field of energy and a regional fund for financing development projects.

(b) *Regional bond markets*

The development of regional bond markets is high on the agenda of policymakers and monetary authorities in many developing countries.<sup>54</sup> 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

Table 3.6

## PORTFOLIO INVESTMENT ASSETS, ASEAN AND ASEAN+3, 2001–2005

(Stocks in per cent of GDP)

	2001	2002	2003	2004	2005
<b>ASEAN</b>					
Portfolio investment	21.2	21.9	24.4	27.4	26.7
Equity <sup>a</sup>	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
<b>ASEAN+3</b>					
Portfolio investment	22.4	24.2	27.3	29.0	29.2
Equity <sup>b</sup>	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](http://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.

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 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 3.6).

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 Ministers 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).

### **3. *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. Monetary and exchange-rate policy has been by far the most developed area of regional cooperation and integration in Africa.<sup>55</sup> With the two currency unions of the Economic and Monetary Community of Central Africa (CEMAC) and UEMOA, nominal exchange-rate stabilization within the Common Monetary Area (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.

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. 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.



#### **4. Lessons from European monetary integration**

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, as exemplified by the debate surrounding the treaty establishing a European Constitution.

Nevertheless, 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. In general terms, 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 advantages of closer monetary cooperation compared to 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 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.

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 (*TDR 2007*: chap. I; 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 stability 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 (Eichengreen, 2007).

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 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 European Economic and Monetary Union (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 (Eichengreen, 2007).

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 seek loans from 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 undervaluation 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 is an important component of overall monetary conditions. Until the major economies 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.

## **5. Conclusion**

There is a growing recognition that global institutions by themselves are often 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 could 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 governance and the disbursement of loans entails softer conditionality. In any case, given the size of the international capital markets the best alternative for small open economies is regional cooperation.

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 alternative 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 Fagerberg, Knell and Srholec (2004) present a similar argument.
- 2 The concept of competitiveness as defined here is relevant for countries where economic success depends on investment that leads to sustained improvements in productivity. This excludes many of the poorest countries, where capital accumulation can help raise per capita income and living standards simply by allowing a fuller use of underutilized labour and natural resources without altering the efficiency with which resources are utilized.
- 3 Probably the two best-known competitiveness indices, contained in *The Global Competitiveness Report* of the World Economic Forum and in *The World Competitiveness Report* of the International Institute for Management Development, are frequently invoked in policy discussions and economic policy-making. But the way these indices combine the very wide range of individual indicators is not transparent and, more importantly, the complex theoretical issues that underlie the concept of competitiveness are insufficiently discussed. However, Lall (2001) has significantly contributed to a clarification of how these indices are actually constructed.
- 4 A number of additional aspects of innovation are discussed, for example, in UNCTAD (2005 and 2007a).
- 5 If labour mobility within the host country is high, the wage level will be determined by the economy-wide average level of labour productivity, rather than by marginal labour productivity.
- 6 The development effect of FDI for the host economy depends on a range of factors, including the amount of technological spillovers from affiliates to domestic enterprises, the creation of forward and backward linkages, and the effects on domestic investment. The large body of literature on this, including successive UNCTAD *World Investment Reports*, provides ambiguous findings, and shows that much depends on host-country characteristics and the way foreign affiliates operate.
- 7 Looking at developed countries, Scarpetta and Tresselt (2004) point out that in addition to wage bargaining regimes, two main aspects of labour-market policy and institutional settings are closely related to the incentives for firms to undertake investment with a view to expanding and innovating production facilities: (i) the stringency of employment protection legislation, which influences the costs of hiring

and firing, and (ii) the possible interactions between this legislation and industry-specific technology characteristics.

- 8 Note that this example assumes that the innovative and the non-innovative firms operate in different sectors, so that they are not in direct competition. If they operated in the same sector, an attempt to raise sales prices would make the non-innovative firm even more likely to be driven out of the market.
- 9 As argued by Akyüz and Gore (1996), the presence of such an investment-profit nexus played an important role in East Asian industrialization. The investment-profit nexus played an important role also in the growth performance of Western Europe during the three decades after the Second World War.
- 10 However, the developed country will tend to employ a higher stock of capital in production than the developing country. Thus the rate of return over capital (i.e. the absolute profit relative to the value of the capital stock) may be very similar in the two countries. In other words, the example relies on the assumption that the internationally immobile factor – labour – absorbs the entire wealth difference between the developed and the developing country, while the internationally mobile factor – capital – obeys the law of one price.
- 11 Local wholesale and distribution costs also affect trade costs. But since they apply to both imports and domestic goods, they do not affect relative prices to buyers and international competitiveness.
- 12 This is the case, for example, if wage increases are indexed to inflation, and if external supply shocks such as price increases of imports (e.g. oil) have a strong impact on inflation.
- 13 For example, according to Gordon (2003: 208), the average annual rate of growth of labour productivity in the United States during the period of the information and communications technology boom (1995–2000) was about 2.5 per cent.
- 14 Major depreciation or appreciation events here are defined as a change in the real effective exchange rate of 15 per cent or greater in any three-month period between 1970 and 2002; the three quarters following such an event are excluded, so that there can be at most one event within any four-quarter period.
- 15 This is likely to reflect a decline in both imports and domestic income.
- 16 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.
- 17 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 2.1, the empirical evidence rejects UIP when expectations and risk perception are not formed in a “fully rational way”.
- 18 The only multilateral discipline left in the IMF is “avoidance of restrictions on current payments and discriminatory currency practices”. According to Article VIII of the Articles of Agreement members are obliged to avoid such restrictions and must obtain the approval of the Fund to impose “restrictions on the making of payments and transfers for current account transactions”. This article provides the possibility for countries to impose exchange controls on current transactions in situations where the Fund has formally declared a currency to be “scarce” because the demand for a currency threatens the ability of the Fund to supply that currency

- (Article VII). In principle, this scarce-currency clause may help put pressure on surplus countries, but it has never been implemented.
- 19 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.
  - 20 See *TDR* (1997, 2003 and 2006); ILO (2003); UN/DESA (2006).
  - 21 See, for example, the papers in Frankel (1998).
  - 22 See respectively Bhagwati (1991); McLaren (2002); and Oman (1997: 28).
  - 23 The notion of “open regionalism” has, for example, challenged the idea of a simple conflict between regionalism and multilateralism (Kirkpatrick, 1994).
  - 24 See, in particular, Meade (1955); Lipsey (1960); Krauss (1972); Pomfret (1986); and Kowalczyk (1992) for reviews of the literature.
  - 25 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.
  - 26 See Bhagwati (1991); Panagariya (1999); Yeats (1996); and Wei and Frankel (1996).
  - 27 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).
  - 28 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.
  - 29 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 Armim (2007); Polaski (2006); and Ackerman (2005).
  - 30 It should be noted, though, that transaction costs are not always 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.

- 31 The bias has been well documented (see, for example, McCallum, 1995; Rose and Engel, 2002; Anderson and van Wincoop, 2001).
- 32 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).
- 33 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).
- 34 Young (1928) was among the first to recognize the importance of this process to modern capitalist development.
- 35 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.
- 36 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). 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).
- 37 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.
- 38 This is closely associated with the work of Raul Prebisch, drawing on his Latin American experience.
- 39 The member countries of the different regional blocs are listed on pages x-xii above.
- 40 In the Southern Common Market (MERCOSUR), the automobile industry is protected with the highest tariff rate (35 per cent) of the common tariff structure.
- 41 Ministry of Commerce of China website, at: [www.mofcom.gov.cn](http://www.mofcom.gov.cn) (accessed on 2 April 2007).
- 42 See note 41.
- 43 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](http://www.mofcom.gov.cn/ai/8/dyncolumn.html).
- 44 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.
- 45 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

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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).

- 46 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.
- 47 For assessments, see Kawai (2005); Park (2006); and Sohn (2007).
- 48 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).
- 49 Accessed at the website of the Ministry of Finance of Japan: [www.mof.go.jp/english/if/as3\\_070505.pdf](http://www.mof.go.jp/english/if/as3_070505.pdf).
- 50 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](http://www.lahora.com.ec)).
- 51 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-).
- 52 Non-founding country members of CAF are: Argentina, Brazil, Chile, Costa Rica, Dominican Republic, Jamaica, Mexico, Panama, Paraguay, Spain, Trinidad and Tobago and Uruguay.
- 53 ALBA (Alternativa Bolivariana para la América) is a regional integration initiative comprised of Bolivia, Cuba, Nicaragua and the Bolivarian Republic of Venezuela.
- 54 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.
- 55 The East Caribbean Currency Union is discussed in *TDR* (2006: 131).



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