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*Chapter II*

## GLOBALIZATION, REGIONALIZATION AND THE DEVELOPMENT CHALLENGE

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***Chapter II***

# GLOBALIZATION, REGIONALIZATION AND THE DEVELOPMENT CHALLENGE

## A. Introduction

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

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

However, as discussed at some length in previous *Trade and Development Reports* (*TDRs*), past experience does not support the claim that strong market-led growth and development will be unleashed simply by eliminating inflation, downsizing the public sector, strengthening property rights and opening up as rapidly as possible to foreign trade and capital.[1] Last year's *TDR* examined how the loss of policy space has made it more difficult for developing countries to reduce the income gap with developed countries. It concluded that external influences on national policy targets have become stronger and the trade-offs between internal and external objectives have intensified, in many cases to the detriment of local development goals. It suggested that multilateral structures needed to be more inclusive and flexible if gains from closer integration into the world economy were to be more widely shared. It also suggested that new multilateral disciplines would be necessary, particularly in the area of international finance, if more balanced outcomes were to be achieved. However, multilateral arrangements are not the only option for fashioning collective and coordinated responses to the challenges confronting developing countries in an increasingly interdependent world economy. Indeed, following the failure of the international financial institutions to manage the financial shocks and crises towards the end of the 1990s, and given the slow progress of the Doha Round of multilateral trade negotiations, regional arrangements have assumed a more prominent place on the international development agenda. Accordingly, this *TDR* looks at whether and how regional integration and cooperation might help strengthen the development policy agenda and rebalance international economic governance.

There is a considerable body of literature, mostly deriving from international trade theory, which views this trend with alarm, believing it distracts (or even subtracts) from the optimal gains it deems possible from a truly open global system.[2] From this perspective, regionalization is a "stumbling block", worse still, it is an "insidious" or even "degenerate" trend.[3] However, while regional agreements may have played some role in boosting regional trade and investment at the expense of multilateral transactions, it is far from clear that this is inevitably the case.[4] Much of the analysis contained in this literature relies on a highly stylized model of the global economy, which downplays (or ignores altogether) some of the more fundamental forces behind regionalization in favour of a singular fixation with the static welfare gains attached to a maximal level of openness and improved allocative efficiency.

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

# B. The limitations of conventional thinking

### 1. *Theoretical approaches to regional integration*

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

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

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

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

The more puzzling issue for conventional trade economists is why, given that in most cases their overall impact appears to be rather small, regional agreements have proliferated in recent years, even as multilateral trade liberalization has been advancing. Explanations have turned to "political economy". According to the trade diversion school, regional arrangements have become a vehicle for rent-seeking by well-organized groups, in opposition to the wider interests of the disorganized majority, leading to a world of increased transaction costs and growing protectionism akin, on some assessments, to the situation in the 1930s (Bhagwati, Greenaway and Panagariya, 1998). From this perspective, regionalization has generated a "spaghetti bowl" of intertwining agreements, which clog up the workings of the trading system and pose a threat to a truly free trade order.

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

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

According to some observers, this domino effect will build support for a fully open world economy only if the agreements bring together members from the North and the South (Schiff and Winters, 2003). Others believe that goal can best be served by a multiplicity of regional agreements of all shapes and sizes (Ethier, 1998). What unites these with the more sceptical voices is their 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.[9]

Attempts within conventional models to link regional trade arrangements to such dynamic forces report large welfare gains: up to 10 per cent of GNP (Brown, 1992; Nielsen, 2003); but these often require ad hoc assumptions about strong trade-productivity links and large spillovers from FDI. The presence of dynamic gains means that no core propositions – including those associated with comparative advantage – can be embraced without strong qualifications. It also casts serious doubts on the standard benchmarking approach to policies adopted in much of the discussion on regional dynamics.[10]

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

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

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

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

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

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

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

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).

## C. Regionalization and policy cooperation

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

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

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

Historical experience, including that of East Asian development, confirms the importance of a broad domestic industrial base for sustained growth and development, given its potential for raising the levels of productivity, employment and incomes. That potential derives, on the supply side, from a predisposition to scale economies, specialization, technological change and learning, and the complementarity of investment decisions; and on the demand side, from favourable price and income elasticities.[14] Successive rounds of increasing productivity growth, rising demand and increasing returns to scale fuel a virtuous growth circle of expanding output, employment and consumption. But industrial activity is also important because it contributes to a dynamic environment in which rent-seeking through innovation can help strengthen the links between profits and capital formation, which is a critical nexus in establishing a cumulative growth process. As the market grows, and as technological progress lowers the costs of coordination, new opportunities for product differentiation emerge, especially in specialized intermediate and capital goods sectors, but also through a growing variety of consumer and producer goods.[15] This process, whereby firms also divest existing functions to new specialized firms, implies increased market transactions across more and more firms in the same sector. All this adds greatly to the linkage constellation behind successful growth dynamics (Hirschman, 1989).

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

***Table 2.1***

**MANUFACTURING VALUE ADDED, TOTAL TRADE AND TRADE IN MANUFACTURES, EU-15, NAFTA AND EAST ASIA, 1991–2005**

*(Per cent)*

| | *1991* | *1995* | *2000* | *2005* |
|---|---|---|---|---|
| | Share in world manufacturing value added | | | |
| EU-15 | 29.8 | 27.6 | 23.6 | 27.6[a] |
| NAFTA | 24.9 | 24.9 | 30.5 | 25.4 |
| East Asia[b] | 25.3 | 29.5 | 29.4 | 29.7 |
| Total | 80.0 | 82.1 | 83.5 | 82.7 |
| | Share of total trade in world trade | | | |
| EU-15 | 43.2 | 39.4 | 35.6 | 35.2 |
| NAFTA | 17.9 | 18.0 | 22.3 | 17.8 |
| East Asia[b] | 16.6 | 18.3 | 18.1 | 19.1 |
| Total | 77.7 | 75.8 | 75.9 | 72.2 |
| | Share of region's manufactured trade in world manufactured trade | | | |
| EU-15[c] | .. | 39.9 | 36.0 | 36.4 |
| NAFTA | .. | 19.1 | 24.0 | 18.8 |
| East Asia[b] | .. | 20.5 | 20.4 | 22.2 |
| Total | .. | 79.5 | 80.4 | 77.4 |
| | Share of intraregional trade in manufactures in world trade in manufactures | | | |
| EU-15[c] | .. | 24.9 | 21.2 | 21.2 |
| NAFTA | .. | 7.9 | 11.1 | 7.8 |
| East Asia[b] | .. | 8.0 | 8.2 | 10.3 |
| Total | .. | 40.7 | 40.5 | 39.3 |

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

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

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

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

ternal and external integration.[17] Exports enlarge the size of the market and thus allow scale economies to be further exploited, while a growing outward orientation also exposes firms to new products and processes, and to new sources of competition. These considerations apply to outward orientation generally, but for many developing countries that are at an early stage of industrial development, a regional orientation involving countries at a similar level of development may be considered a more viable option, because the initial foreign competition may be less difficult to handle and the technological gap vis-à-vis competitors from more advanced countries outside the region may be easier to close.

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

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

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

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

> Formal regional cooperation is not a precondition for de facto integration; in general there will be a dynamic interaction between the two.

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

## 2. *Bridging gaps and battling constraints*

The bulk of international inequality is explained by differences between regions rather than differences within them. Moreover, evidence of regional convergence from Europe and Asia suggests that economic performance is in part defined by similar initial conditions, capabilities, attitudes and social institutions among neighbouring countries. The previous section has suggested that key to realizing economic potential in poorer countries (and reducing inequality) is the emergence of an industrial division of labour at the national and regional levels. But this process can be hindered by the imperfect flow of information and high transaction costs. Bridging these gaps and overcoming the constraints on industrial take-off, diversification and sustained catch-up growth, require public policies that take a long-term view for mobilizing and directing resources, rather than aiming at maximizing short-term returns on capital. The resulting intertwining of economics and politics requires a capable government bureaucracy with access to a wide array of policy measures, including industrial policies, and the room to tailor these to local conditions (Kozul-Wright and Rayment, 2007).

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

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

> Shared challenges might best be handled through a more limited membership whose priorities are similar and between whom trust, consensus and a sense of common purpose can be easily established.

However, even among the developed countries, it was recognized that shared challenges might best be handled through a more limited membership whose priorities were similar and between whom trust, consensus and a sense of common purpose (and ownership of actions) could be more easily established. This was apparent from the outset of post-war international cooperation, when financial support for European reconstruction was made the stated aim of the fledgling World Bank. It was even more apparent when the Marshall Plan assumed a key role in reconstruction from the late 1940s, and brought with it the creation of the first institutions for regional economic cooperation in Western Europe (see also chap. VI, sect. C). The regional dimension was retained as the World Bank moved into development finance proper, including with the creation of (its sister) regional development banks, beginning with the Inter-American Development Bank in 1959, and later, the (more independent) sub-regional banks, particularly in Latin America and the Caribbean (Culpepper, 2006: 54–61). These institutions were, however, more concerned with generating a sufficient flow of resources to member countries that faced tight constraints on international borrowing than with fostering greater economic integration per se.[19] Regional trade arrangements – particularly once their legitimacy was confirmed in rules under the General Agreement on Tariffs and Trade (GATT) – offered more tangible opportunities for a collective response to the constraints on catch-up growth.[20]

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

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

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

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

Similar considerations extend to other constraints on the growth process, such as those associated with technological development, where most developing countries rely heavily on accessing technology from abroad and absorbing it within local production systems. Meeting this challenge will require appropriately crafted national policies and institutions. Still, national innovation systems may well be devised with an explicit regional dimension involving collaborative research, training schemes and information gathering, and may extend to complex institutional issues such as those relating to the design of intellectual property regimes. They may also be better tackled by harmonizing rules and laws on a regional basis and by pooling resources to ensure their more effective management in light of local needs and conditions. While in many respects the European experience may not be an appropriate model for regional cooperation among developing countries, which has to be conceived under very different historical, economic and political circumstances, it suggests that in order to meet common challenges, such as accelerating diversification into dynamic sectors, upgrading the industrial structure and raising agricultural productivity, pooling regional resources might be a sensible way forward (see chap. VI, section C).

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

### 3. *Global financial governance and regional cooperation*

Financial and monetary cooperation among developing countries has received particular attention since the 1990s, partly because the development prospects of many countries have been shaped more by the globalization of finance than by global trade expansion. Financial crises in emerging market economies illustrated the risks stemming from the volatility of private 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). The IMF had not only wrongly assessed the situation preceding the crises, but also the terms and conditions of its financial support were increasingly perceived as counterproductive, as they implied fiscal and monetary tightening that actually aggravated the economic recessions. Moreover, dissatisfaction among governments grew, because conditionality went beyond what could be justified by the need to safeguard the resources of the IMF, thereby unduly violating the sovereignty of the borrowing countries, and because it did not differentiate between country-specific circumstances.

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.

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

The institutional and political hindrances to moving forward remain considerable, and progress in implementing concrete measures has been tentative. Fully-fledged regional systems of financial surveillance and policy coordination or exchange-rate coordination are yet to be elaborated.[22] But with only limited reforms in the governance of global finance, building collective defence mechanisms against external shocks and strengthening macroeconomic coordination at the regional level remain firmly on the agenda of many developing countries. In all geographical regions, considerable attention has focused on how to achieve exchange-rate stability in order to prevent crises, and how to bolster trade and competitiveness, including the use of regional currencies.

The fact that countries differ in terms of their creditworthiness and the types of flows they are likely to attract raises the possibility of different types of financial cooperation, coordination and surveillance emerging at the regional level. For countries with no or only limited access to 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 inflow of choice for many policymakers. However, there is a need to carefully weigh the costs as well as the benefits of FDI, and regional dialogue and cooperation may be helpful in this regard. Regional coordination and monitoring might provide useful support for fashioning the kind of policy space needed to effectively manage FDI, particularly in those dynamic sectors where there is a danger of overinvestment and destructive export competitiveness. Uncoordinated policies aimed at attracting FDI can result in a race to the bottom as governments cut regulations and offer generous tax incentives in a wasteful bidding war to attract TNCs, rather than striking a fine balance between costs and benefits (*TDR 2005*, chap. III, sect. F). Regional arrangements may be a sensible way to manage some of these issues by forging consensus and establishing a common bargaining position on areas such as the harmonization of corporate codes, contract enforcement, tax incentives and avoidance, and transfer pricing.

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

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

# Notes

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

17 The relationship between openness and growth is a long-standing source of controversy (see, for example, Agosin and Tussie, 1993; Frankel and Romer, 1999; Rodriguez and Rodrik, 2000; Dollar and Kraay, 2001; and Rodrik, 2000). A review of the debates is also provided by Kozul-Wright and Rayment, 2007. It is worth noting that even for Britain, "all the figures suggest that ... it was the success of British industries that caused exports to grow, not the success of British overseas trade that made industries grow" (Ogilvie, 2000: 123). On the evidence of which kinds of firms export, see Bernard et al., 2007.

18 Intra-industry trade in Western Europe was already important in the 1950s, but the drive to keep reducing transaction costs by removing administrative and other obstacles often came from the enterprise sector. This was the case with the 1992 Single Market Programme.

19 As Culpepper (2006: 44) notes, this was perhaps less true of the African Development Bank, thanks in part to wider regional political circumstances and the exclusion of non-borrowing industrial country members until 1982.

20 For differing assessments of the evolving Latin American experience with regional agreements in the 1950s, see Mikesell, 1961, and Urquidi, 1961.

21 This is closely associated with the work of Raul Prebisch, drawing on his Latin American experience.

22 For assessments, see Kawai, 2005; Park, 2006; and Sohn, 2007.

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