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Strengthening subregional, regional and interregional dialogue and cooperation and their contributions to economic integration and development

Strengthening subregional, regional and interregional dialogue and cooperation and their contributions to economic integration and development: Policy lessons for development-oriented regional integration

Note by the UNCTAD secretariat

Executive summary

This note discusses how strengthening subregional, regional and interregional dialogue and cooperation can contribute to the economic integration and development of developing countries and countries with economies in transition. The identification of key constraints to regional integration and ways of addressing the challenges is crucial for fostering regional integration processes, and an analysis of the approaches that work best to boost productive capacities in a framework of regional integration is needed. This note attempts to distil some key policy lessons for development-oriented regional integration and identify important gaps in the understanding of these issues.

This note explores the conditions under which trade might become an engine of growth in a process of regional integration, suggesting that it is necessary to go beyond trade liberalization and trade facilitation and that trade policy should be integrated in a broader policy framework aimed at the development of productive capacities at national and regional levels. Productive integration as the basis of development-oriented regional integration is discussed. The issue of infrastructure continues to be pivotal among the supply-side issues to be addressed for deeper regional productive integration. This note highlights the potential role of regional value chains in development-oriented regional integration and considers issues related to financing for such integration. Bridging the gap between the investment needs – infrastructure needs in particular – of developing countries and countries with economies in transition and the finance currently available for this purpose is critical for any form of deeper regional productive integration.

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Introduction

1. The development-oriented economic integration of developing countries in the world economy can spur global growth and reduce poverty and the lack of equality. However, identifying successful ways and means of achieving such integration remains a daunting challenge. Given deficient global demand and a less favourable trade environment, exports-led growth strategies are reaching their limits. Adjusting to the changing dynamics of the world economy will necessarily involve greater reliance on regional and domestic markets. Regional integration at various levels, however, faces diverse challenges, and solutions may involve a range of policies and institutional options.

2. This note discusses how strengthening subregional, regional and interregional dialogue and cooperation can contribute to the economic integration and development of developing countries and countries with economies in transition. Approaches that work best to boost productive capacities in a framework of regional integration need to be analysed and discussed, and this note attempts to distil key policy lessons for development-oriented regional integration and identify important gaps in the understanding of these issues.

3. Chapter I explores the conditions under which trade might become an engine of growth in a process of regional integration, and suggests that it is necessary to go beyond trade liberalization and trade facilitation and that trade policy should be integrated in a broader policy framework aimed at the development of productive capacities at national and regional levels. Chapter II discusses productive integration as the basis of development-oriented regional integration. The issue of infrastructure continues to be pivotal among the supply-side issues to be addressed for deeper regional productive integration. The chapter highlights the potential role of regional value chains in development-oriented regional integration. Chapter III addresses issues related to financing for such integration. Bridging the gap between the investment needs – infrastructure needs in particular – of developing countries and countries with economies in transition and the finance currently available for this purpose is critical for any form of deeper regional productive integration. It is necessary to develop mechanisms for financing large investment needs in these countries, especially with regard to infrastructure development.

I. Conditions under which trade might become an engine of growth in a process of regional integration

A. Exports-led growth strategy could reach limits in an era of feeble growth of international trade

4. Growth acceleration in many developing countries during the 1990s, and in particular during the period 2003–2008, was associated with an increased proportion of international trade in the composition of their aggregate demand. Up to the time of the financial crisis, rapid output growth in a number of developing countries and countries with economies in transition was the result of a strong increase in exports of manufactures to developed countries. This contributed in turn to the higher exports earnings of other developing countries that relied on exports of primary commodities. Combined with the generally favourable external economic environment, such as growing levels of imports by developed countries and historically high commodity prices, the greater outward orientation of developing countries and countries with economies in transition contributed – and in many cases led – to their economic growth.

5. International trade in the two decades preceding the current crisis expanded more than twice as fast as global output, at annual averages of 6.8 per cent and 3.0 per cent, respectively. The crisis of 2008–2009, however, proved a watershed. After rebounding strongly in 2010 on the back of internationally coordinated fiscal and monetary measures to kick-start growth, international trade lost momentum in 2011 and entered a period where its growth has been slower than that of global output. Given insufficient global demand, it is highly unlikely that international trade alone will be able to kick-start global growth.[1]

6. A key problem for policymakers in developing countries and countries with economies in transition, including those with a large share of manufactures in their exports, is that the growth of exports is likely to be adversely affected by continued slow growth in the final expenditures of developed countries for several years to come. In a number of the former countries, the production of manufactures for the world market has driven the expansion of their formal modern sectors. In most, however, domestic demand has not increased at the same pace, partly due to weak linkages between the exports sector and the rest of the economy, including in participation in global value chains (GVCs), and partly due to the strategy of strengthening international competitiveness by keeping wages low.

7. Such a strategy could eventually reach its limit, as low wages directly dampen domestic demand growth as well as, eventually, demand for exports. In the current global climate, the slow deleveraging process and reparation of balance sheets in developed countries adds to the problem of insufficient demand. In such circumstances, continuing with exports-led growth strategies that are based solely on wage and tax competition would exacerbate the harm caused by slower growth in exports markets and reduce any overall benefits.

8. For commodity-exporting developing countries and countries with economies in transition, the lack of demand for manufactures translates to a slower growth in demand for their main export items. As the increasing demand for commodities in rapidly growing developing countries resulted in higher international prices for most commodities before the crisis, the weakening of previous trends is likely to adversely affect commodity prices. In addition, new supply capacities came to the fore in response to high prices, particularly in mining and hydrocarbons. As a result, after reaching a peak in 2011, most commodity prices have gradually been declining.

B. Reorientation to domestic and regional demand

9. Given that the growth prospects of developed countries are likely to be subdued in the medium term, developing countries and countries with economies in transition may need to have a more comprehensive and longer term perspective, which would involve a shift in development strategies that gives greater weight to domestic and regional demand as an engine of growth. Such a move, to a more balanced growth path, could compensate for the adverse impact of slower growing exports to developed countries. In addition, a more balanced growth strategy could be pursued by all developing countries and countries with economies in transition simultaneously, without beggar-thy-neighbour effects.[2]

10. However, moving towards a more balanced growth strategy involves several challenges, which include boosting domestic purchasing power and managing domestic expansion in a manner that avoids an excessive increase in imports. It is also necessary to

[1] UNCTAD, 2014, *Trade and Development Report, 2014: Global Governance and Policy Space for Development* (New York and Geneva, United Nations publication).

[2] UNCTAD, 2013, *Trade and Development Report, 2013: Adjusting to the Changing Dynamics of the World Economy* (New York and Geneva, United Nations publication).

enable the sectoral composition of domestic production to adjust to new demand patterns. Given that the domestic markets of many developing countries and countries with economies in transition are small, a regional market may be needed to enable producers to reap the benefits of economies of scale. Shifting the focus of development strategies to domestic markets does not mean minimizing the importance of the role of exports. On the contrary, exports could expand further if several regional integration partners were to achieve higher economic growth at the same time.

11. The possibility of rapidly changing to a more regional demand-oriented growth strategy largely depends on how closely the sectoral structure of domestic production is linked to the pattern of regional demand. This linkage may be particularly weak in countries that export a large proportion of primary commodities. Historical experience shows that regional integration among countries is more difficult to achieve if their productive capacities are less developed and economies less diversified. This is because countries in a region that rely predominantly on the production of commodities will not be in a position to provide for each other's increasing needs for manufactured and capital goods.

12. Data on intraregional trade indicate that African countries trade the least among themselves.[3] In 2013, only 14 per cent of the total trade of African countries was with intraregional partners. In Latin America, the comparable figure is 20 per cent. Developing Asia is more comparable with developed countries; at 55 per cent, its intraregional trade is only surpassed by that in developed countries, at 67 per cent. It is important to note that developing Asia is also the part of the world with the highest gross domestic product (GDP) growth, in both the pre-crisis and post-crisis periods, and with the strongest manufacturing hubs. Countries with economies in transition, due to the prolonged process of transition from centrally planned to market economies and opening up of their economies, have seen their share of intraregional trade reduced from 27 per cent of the total in 1995 to 17 per cent in 2013.

C. Trade as an engine of growth

13. As the data on intraregional trade show, trade might be an engine of growth in a process of regional integration. Contrasting the experiences of Africa and Latin America on one hand and of developing Asia on the other suggests that the productive structure and policy frameworks of individual countries or regions have a bearing on the type and direction of trade, as well as on the overall growth dynamic.

14. If left only to market forces, a country engaging in international trade specializes in part according to the existing pattern of factor endowments across countries (comparative advantages), and also in keeping with the wider set of its productive capacities that influence the productivity performance of firms and the influence and strategies of the dominant players in international markets. For instance, an abundance of natural resources, coupled with a policy framework largely informed by the economic policy prescriptions of the Washington Consensus, has resulted in the degrading of the manufacturing capacities (premature deindustrialization) of many economies in Africa and reinforcement of a pattern of specialization based on the exploitation of natural resources.[4] The share of manufacturing in Africa fluctuated around 14 per cent of GDP from the 1970s onwards, began to decrease in the late 1990s and dropped to 9.1 per cent in 2012. In contrast, shares

[3] UNCTAD secretariat calculations, based on data from UNCTADStat, available at http://unctadstat/EN/Index.html (accessed 9 March 2015).

[4] J Williamson, 1990, *Latin American Adjustment: How Much Has Happened?* Institute for International Economics, Washington, D.C.

of non-manufacturing activities in industry (mining and quarrying, construction and electricity, gas, water and sanitary services) have been increasing; in 1970, they were roughly half of the total industrial value added, while today they represent three quarters. The low level of intraregional trade in Africa is thus due in large measure to weak productive capacities and the lack of economic diversification. It is this underlying pattern of structural transformation that has hampered regional trade and integration in Africa.

15. Intraregional trade in Latin America, although its level is somewhat higher than in Africa, has also been hampered by the productive and trade specializations of the region. The boom in prices of raw material that resulted from strong demand from Asia has been instrumental in the last 15 years in deindustrialization and respecialization in commodity production in many Latin American countries. Exceptions to these trends are some South American countries that used a part of higher fiscal revenues to finance industrial policies and Mexico and some Central American countries, which specialized in labour-intensive manufactures (mostly assembly) destined for the United States of America market.[5]

16. Among developing countries in Asia, the high share of intraregional trade in total trade is based on the existence of strong regional production networks. This characteristic is particularly pronounced in East and South-East Asia, where such networks have been developed the most (according to one study, production networks in East Asia are the most advanced in the world in terms of magnitude, extensiveness and sophistication).[6] While trade in parts and components and final assembly in production networks has grown more rapidly than total world trade in manufacturing in all parts of the world, this type of trade has been especially dominant in East Asia. China has emerged as a pivotal player in regional production networks, as the premier centre of final assembly and the exporter of final goods to extraregional markets.[7]

17. A strong industrialization drive, with particular attention to upgrading manufacturing production, is the basis of regional production networks in East Asia. Complementarity among producers in a country tends to emerge with the development of manufacturing production. As the specialization and division of production activities (along the lines of Adam Smith's example of a pin factory) make it possible to divest or externalize activities, linkages are generated first among producers in one country but, given sufficient regional infrastructure, extend across borders. In particular, as successful integration in the global economy depends on sustained productivity growth, building a strong manufacturing base remains a key component of a successful trade strategy in most developing countries.

D. Policy lessons

18. A number of empirical regularities associated with manufacturing must be considered in advancing a strategy of integration in the global economy that seeks to move from one based solely on comparative advantages, as follows: the contribution of manufacturing to growth has been found to be greater than its share in total output; faster growth in manufacturing output generates faster growth in manufacturing productivity; and

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5 Economic Commission for Latin America and the Caribbean, 2014, *Regional Integration: Towards an Inclusive Value Chain Strategy* (Santiago, United Nations publication).

6 F Kimura and A Obashi, 2011, Production networks in East Asia: What we know so far, Working Paper No. 320, Asian Development Bank Institute, Tokyo.

7 P Athukorala, 2010, Production networks and trade patterns in East Asia: Regionalization or globalization?, Working Paper Series on Regional Economic Integration No. 56, Asian Development Bank, Manila.

faster growth in manufacturing is linked to the faster growth of output and productivity in other sectors of the economy. A strong positive correlation between a country's level of income and the degree to which its economy is diversified also appears to be closely associated with expanding industrial capacity.

19. The link of broad trends to causality is, of course, not automatic. Dynamic and creative impulses are not unique to the manufacturing sector. However, evidence shows that manufacturing carries a greater likelihood of creating both supply-side (specialization, economies of scale, technological progress and skills upgrading) and demand-side (favourable prices and income elasticity) advantages that together may help trigger and sustain a virtuous circle of rising productivity, employment and incomes. It follows that building strong links between investment and exports is likely to be critical in generating dynamic gains from participation in the international division of labour.

20. One way to expand trade is through trade facilitation, that is, improving procedures and institutions related to the flow of goods across borders.[8] Such reforms are not easy to implement, however, and commonly cited examples such as customs administrations and procedures are part of an ongoing process of building developmental states as much as a quick fix of corrupt border practices. Reforms of customs administrations are likely to be part of more broad reforms of the judiciary or civil services. Trade facilitation on its own is much less effective than if undertaken as part of a coherent effort to build the institutional underpinnings of a modern market economy. Implementing such reforms takes time and addresses only part of the problem. A much greater constraint in many developing countries and countries with economies in transition is their productive structure, which severely limits possibilities for intraregional trade.

21. Exports capacity may also be strengthened through the presence of foreign affiliates in a domestic economy. However, efforts aimed simply at attracting foreign direct investment through macroeconomic stability, bilateral investment treaties, favourable tax policies and weak labour market and other regulations, even when they do succeed, risk locking static advantages inside exports platforms, with minimal linkages to domestic industry. This risk is particularly high if trade flows are based on preferential market access that requires production inputs to be sourced from a trade-country partner.

22. There is thus growing interest in including a stronger regional dimension in the development strategy of developing countries. One study, for example, emphasizes that larger developing economies are shifting their development strategies to regional production networks and to regional industrial policy.[9] This is especially true of Brazil, China, India, the Russian Federation and South Africa and their surrounding regions. While China has advanced the furthest on this path, the four other States are also repositioning their economies to become regional hubs.

23. In effect, such efforts may best be understood as an attempt to put in practice a concept of developmental regionalism.[10] This concept, or development strategy, originally proposed in the context of possible development strategies for least developed countries,

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[8] See for example B Hoekman and A Nicita, 2011, Trade policy, trade costs and developing country trade, *World Development*, 39(12): 2069–2079.

[9] W Milberg, X Jiang and G Gereffi, 2014, Industrial policy in the era of vertically specialized industrialization, in: JM Salazar-Xirinachs, I Nubler and R Kozul-Wright, eds., *Transforming Economies: Making Industrial Policy Work for Growth, Jobs and Development*, 151–180, International Labour Organization, Geneva.

[10] UNCTAD, 2011, *The Least Developed Countries Report 2011: The Potential Role of South-South Cooperation for Inclusive and Sustainable Development* (New York and Geneva, United Nations publication).

accepts the potential benefits that come with greater openness and access to new technologies, but rejects the finance and market-led approach to globalization that has skewed such benefits in recent years. Developmental regionalism aims at maximizing the benefits of cross-border economic linkages with neighbouring markets and enterprises and through regional cooperation and policy coordination. This goal is not an end in itself, but only the means to accelerate human, economic and social development, with a particular focus on building the productive capacity and capabilities on which strong productivity growth ultimately depends. As such, developmental regionalism is concerned with both internal economic development and domestic integration, as well as the strategic integration of a region in the world economy.

24. There are major opportunities for the achievement of economies of scale through the provision of various kinds of regional public goods, which could benefit developing countries in regional groupings. Such goods may include various types of physical infrastructure supporting transport, communications and energy, as well as science and technology infrastructure and innovation systems.

25. In terms of a policy framework, the development of regional production systems is anchored in policies that go beyond trade liberalization towards regional industrial and structural transformation. More integrated policy frameworks centred on economic and social upgrading in regional production systems are required, in which trade policy is seen as a tool of development whose success is measured not only in terms of how much trade is growing, but also the quality of exports (value added) and the impact on the development of productive capacities of the economy. It is evident that at a national level, trade policy should be integrated in a broader policy framework that aims at developing productive capacities. If trade is to become an engine of growth in a process of regional integration, macroeconomic and industrial cooperation at a regional level are also required.

II. Productive integration as the basis of development-oriented regional integration

A. Productive capacities

26. As suggested in chapter I, regions where intraregional trade is low are also the regions with weak productive capacities. The only exception is developing Asia, and East Asia in particular, where a deliberate attempt to build a strong manufacturing sector at national levels has been crucial in the development of regional production networks. Policies may thus make a difference in the pattern of integration and the advantages countries derive from closer integration in the international economy.

27. The term productive capacities refers to the expansion of productive resources, the acquisition of technological capabilities and the creation of production linkages that enable countries to produce a greater range of increasingly sophisticated goods and services and facilitate their beneficial integration in the global economy. The key to achieving sustained development and poverty reduction is to place the development of productive capacities – and the related expansion of productive employment – at the heart of national and international policies to promote economic growth.[11]

[11] UNCTAD, 2006, *The Least Developed Countries Report 2006: Developing Productive Capacities* (New York and Geneva, United Nations publication).

28. The development of productive capacities occurs through the three interrelated processes of capital accumulation, technological progress and structural transformation. Capital accumulation and technological progress not only lead to the expansion of existing productive potential but also facilitate processes of diversification, from sectors characterized by diminishing returns to sectors characterized by increasing returns. Structural transformation leads to changes in the intra and intersectoral composition of production and the pattern of linkages among enterprises and sectors. The emerging production structure, in turn, influences the potential for further investment and innovation.

29. Such processes may also lead to a shift in the form of integration of developing countries and countries with economies in transition in the global economy. Domestic firms that cross various thresholds in terms of size and technological know-how tend increasingly to trade abroad. Exporting, in turn, enlarges the size of the market, and thus allows economies of scale to be further exploited, while a growing outward orientation also exposes firms to new products and processes, as well as new sources of competition. Industrial differentiation broadens the scope for intra-industry trade, particularly among countries with similar income levels and technological capabilities.

30. Manufacturing firms, as they grow, may also seek further advantages by establishing affiliates abroad. The resulting foreign direct investment flows are predominantly by large and technologically sophisticated firms seeking to augment rents from their specific assets, with some combination of cost differentials, market size and technological sophistication determining location. In addition, as more and more countries advance, considerable foreign direct investment flows in the same sector are likely, through intra-industry flows. If such flows coincide with the strengthening of domestic capacities through appropriate policy measures and support, the potential for beneficial spillovers is likely to increase.

31. Some production abroad involves the replication of entire plants, but there may also be a vertical disintegration of industries geographically through foreign direct investment, as individual activities are detached and relocated. The degree of fragmentation will vary by sector, depending on the extent to which new technologies help reduce coordination and transportation costs, as well as on the intensity of linkage of particular activities. The resulting international production networks that emerge from such processes are likely to accelerate the cross-border movement of component parts and semi-finished products, which in many cases takes the form of intra-firm trade.

B. Institutional and supply-side issues

32. If neighbouring countries undergo a similar process of industrial take-off and diversification, cross-border linkages at sectoral and firm levels may be expected to intensify. Productive integration through trade flows and production-sharing ultimately depends on the decisions of firms, not Governments. However, national industrial policies may support this process, and the coordination and harmonization of such policies at a regional level may help make national policies more effective.

33. Once external linkages reach a certain level of intensity, there is pressure from producers – starting at a regional level – to lower or remove various barriers to intraregional trade and investment (including bureaucratic red tape, conflicting legal restrictions and administrative procedures), as well as demands for better transport and communications infrastructure. Such demands are likely to be accompanied by the creation of institutions for closer cooperation.

34. Formal cooperation is not a precondition for de facto integration, but larger and more inclusive gains likely require a dynamic interaction between the two. At first, such cooperation tends to focus on technical issues (trade barriers, standards, etc.) but, as

production and trade systems become more integrated among neighbouring countries, the need for coordination and collaboration grows. Access to larger markets, as a means of achieving economies of scale and diversifying production, has been an enduring rationale for regional arrangements among developing countries.

35. Regional integration and South-South ties among developing countries provide a space for implementing a regional development strategy based on industrialization. Such a strategy has greater chances of succeeding than isolated national strategies, especially in countries with small domestic markets and limited technological capacities. Although a regional strategy might require relinquishing some sovereignty in national policymaking, members may find their policy spaces enlarged through cooperation initiatives in areas where larger markets and shared resources may help promote investment and structural transformation. Proactive regional economic policies and other forms of South-South cooperation that aim to foster structural change should be developed, taking advantage of potential complementarities and specializations among member countries and increasing the productive capacities of less developed members. The creation of regional institutions that facilitate development-oriented regional integration will be required as productive integration progresses.

C. Pivotal role of infrastructure

36. Economic diversification requires significant investments, skills upgrading and, with new products, the need to compete against already established players. Linkages and diversification may offer opportunities for unlocking development gains, but are subject to the existence of an enabling policy environment that promotes the following: human resource development through training, education and research and development; technological innovation to create more competitive suppliers; macroeconomic and income policies supportive to long-term demand growth and investment conditions; and improved infrastructure to overcome supply constraints.

37. Under developmental regionalism, the implementation of strategic trade policies must be consistent with each member State’s domestic industrial policies. Strategic trade policies may include traditional or less traditional tools, such as tariffs, imports and exports quotas and technical and phytosanitary standards. In keeping with its holistic vision of development, regional trade may also be promoted through the coordination of investment in strategic areas such as regional transport and other ancillary infrastructure.

38. Prioritizing investment in strategic areas of common interest and constraint may help overcome historical biases against regional trade, in some instances dating to the European colonial period. Many developing countries, in particular in Africa, are still better connected in terms of logistics to other continents than to some neighbouring countries and, therefore, cannot yet fully benefit from the potential gains of regional integration. In such a context, regional trade facilitation and infrastructure investment projects can directly reduce the transport costs of intraregional trade and unleash a virtuous circle of increasing trade and economies of scale in the transport sector and reducing transport costs, which in turn may further stimulate intraregional trade.[12]

39. There are major unrealized opportunities for regional cooperation, for example in physical infrastructure investment and regional technology hubs that pool resources (the issue of financing is addressed in chapter III). The effectiveness of infrastructure investment and trade facilitation reforms multiplies if projects are planned as part of a

[12] UNCTAD, 2011.

cross-border or regional initiative. The development of transport corridors provides an example of an area where public and public–private investment and joint regional efforts focus on removing commonly identified trade facilitation and transportation bottlenecks across national borders. Developing cross-border infrastructure helps strengthen regional integration initiatives. Building transnational structures such as roads, railways, waterways, air transport links, telecommunications and energy supply lines (development corridors) has an even stronger impact on the development of the productive capacities of neighbouring countries if accompanied by local development projects in different sectors, such as agriculture and industry.

40. The issue of regional infrastructure is especially pertinent in the 32 landlocked developing countries (16 in Africa, 10 in Asia, four in Central and Eastern Europe and two in Latin America) that share one common feature, namely the lack of direct territorial access to the sea, often coupled with remoteness from major markets. This feature has a profound impact on the scope and dynamics of the integration of these countries in the global trading system. Their dependence on transit transport routes and transit facilities for merchandise trade increases transaction costs, reduces international competitiveness and discourages foreign investors. A regional integration process that focuses attention on regional infrastructure would substantially improve the development prospects of landlocked developing countries.

41. Among the successful examples of an emphasis on the development of regional infrastructure as a precondition for deeper regional productive integration is the Spatial Development Initiatives programme launched by South Africa. Of the 11 initiatives, the most successful has been the Maputo Development Corridor, which involves the Maputo Corridor toll route, the railway from Ressano Garcia to Maputo and the Maputo port and harbour, as well as projects in agriculture, mining and tourism. Based on the success of this initiative, the Southern African Development Community adopted the Regional Infrastructure Development Master Plan in 2012.

42. Another example is the Greater Mekong Subregion project, coordinated by the Asian Development Bank, which began in 1992. The project involves all major States and actors in the area, including China, Thailand, Viet Nam, all three least developed countries in the region (Cambodia, the Lao People's Democratic Republic and Myanmar) and the Association of South-East Asian Nations and its development partners, including Japan. The core goal is to enhance infrastructure for industrial development in the region by implementing programmes in the areas of human resource development, transport, telecommunications, energy, tourism, trade facilitation, investment and agriculture.[13] The basic strategy is to attract private investment to the region and facilitate cross-border trade, investment and tourism by strengthening infrastructure linkages across the region.

43. There are also successful examples of regional projects in Latin America. One of the most comprehensive is the Initiative for the Integration of the Regional Infrastructure of South America, launched in 2000. The project has identified transport, communications and energy infrastructure as crucial for closer regional integration in South America and, inter alia, developed a continental energy strategy for 12 South American countries.

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[13] D Chang, 2011, Opportunities for least developed countries in integrating East Asia: From new regional division of labour to inclusive regional development network, Background Paper No. 1, *The Least Developed Countries Report 2011*, UNCTAD.

D. Global and regional value chains as a possible way forward

44. Increased production complementarities between developed and developing countries and further fragmentation of production processes in many different sectors could imply a growing weight in the decisions of large foreign firms in shaping future economic opportunities and outcomes in poorer countries. This need not be a problem in itself, unless it further reduces policy autonomy in developing countries regarding the formulation of development strategies that emphasize building national enterprises, capabilities and markets.

45. Critical to the likely development impact of GVCs is the extent to which they generate spillovers, particularly in the areas of technology and skills. There are concerns that the more geographically dispersed pattern of production activities associated with GVCs may actually reduce spillovers, given that the package of technology and skills required in any one site (country) becomes narrower and because cross-border backward and forward linkages are strengthened at the expense of domestic ones. Furthermore, if only a small part of a production chain is involved, transnational corporations have a wider choice of potential sites – since these activities take on a more transferable character – and this strengthens their bargaining position vis-à-vis a host country. This could engender excessive and unhealthy competition among developing countries as they begin to offer transnational corporations increasing fiscal and trade-related concessions, and thereby aggravate inequalities in the distribution of gains from international trade and investment between such corporations and developing countries.[14]

46. The fundamental policy challenge for developing countries and countries with economies in transition is to ensure that participation in GVCs is one of several complementary components of a development strategy that focuses on a rapid pace of capital formation, economic diversification and technological upgrading. Significantly, with regard to first-tier newly industrialized economies in East Asia, development strategies included import substitution industrialization in an effort to move from the assembly of imported components to their domestic production.

47. If creating greater domestic value added, output, incomes and jobs from exports are the development objectives of industrial and trade policies, then country experiences show that these may not necessarily be achieved through linking in GVCs. Some countries with high participation in GVCs have witnessed falls in their exports-to-GDP ratios and domestic value-added content in their exports.

48. The seminal work of authors such as Gary Gereffi, Raphael Kaplinsky, Timothy Sturgeon and others has resulted in a large body of literature on issues related to GVCs. One recent study providing an empirical analysis of GVC participation suggests that countries that have gained from such participation show positive gains in exports-to-GDP ratios and value added in exports.[15] Switzerland and the United States are notable examples. Mexico and South Africa have experienced positive changes in both, but have low levels of participation in GVCs, indicating that gains come from domestic firms. China has a high level of participation in GVCs; its exports-to-GDP ratio declined by nine percentage points in 2009, compared to 2005, yet it has gained in terms of percentage change in domestic value added in its exports. The figures for the Russian Federation are similar, although the change in domestic value added in exports was much lower than that of China and it has a much lower share of exports in GDP. With regard to other countries in the group of Brazil,

[14] UNCTAD, 2014.
[15] R Banga, 2013, Measuring value in global value chains, Background Paper No. RVC-8, Development Oriented Integration in South Asia, UNCTAD.

China, India, the Russian Federation and South Africa, the level of participation of Brazil in GVCs is low, and it has gained in terms of domestic value added in exports, while India also has a low level of participation in GVCs, yet (although the country has improved its exports-to-GDP ratio) its domestic value-added content in exports has declined.

49. The current organization of many GVCs appears to constrain the emergence of a strong investment-profit nexus in local suppliers in developing countries and countries with economies in transition. Many fiscal measures, for example, amplify the profitability of lead firms. To reverse this, fiscal instruments such as tax breaks and accelerated depreciation allowances need to be used to boost the profits of domestic firms and allow them to set up various reserve funds against risk that may be used to defer paying taxes on profits. In each situation, policymakers must determine the right mix of instruments and mechanisms that leads to sustainable investment and a more diversified and higher value-added economy.

50. As an alternative to GVCs, developing countries and countries with economies in transition might explore the possibility of forming regional value chains. Recently, South-South trade in final assembly has lagged behind the expansion in market opportunities in the South, which suggests that South-South value chains are still weak and underdeveloped. Strengthening such chains should not, however, be approached as a challenge that is independent from building industrial capacity across the South.

51. The potential for building regional value chains in the South seems large. One study, for example, examines the potential of increasing intraregional trade in leather and leather products and possibility of forming regional value chains between member countries of the Common Market for Eastern and Southern Africa, Economic Community of West African States and Southern African Customs Union.[16] The study estimates a dynamic gravity model for the period 2002–2011 and concludes that high tariff and non-tariff barriers hindered the growth of intraregional trade. Removing tariffs on leather and leather products has the potential to increase intraregional trade from $245 million to $997 million per annum, i.e. almost four times the amount. Removing all tariff and non-tariff barriers for all sectors may increase existing average intraregional trade tenfold. There is a large untapped potential, therefore, for increasing intraregional trade in sub-Saharan Africa. A similar conclusion may also be drawn for Latin America and the Caribbean.[17]

III. Financing for development-oriented regional integration

A. Availability of finance: Key problem in underprovision of infrastructure

52. As suggested in this note, infrastructure development is vital for regional integration. It has the power to facilitate and foster intraregional trade and support growth acceleration, poverty reduction and the development of regional markets. However, the underprovision of infrastructure in the developing world is a serious obstacle to sustained development.[18]

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[16] R Banga, forthcoming, Identifying and promoting regional value chains in leather and leather products in Africa, Background Paper, UNCTAD.

[17] Economic Commission for Latin America and the Caribbean, 2014.

[18] M Fay, M Toman, D Benitez and S Csordas, 2011, Infrastructure and sustainable development, in: S Fardoust, Y Kim, C Sepulveda, eds., *Post-crisis Growth and Development*, 329–372, World Bank, Washington, D.C.

53. A key factor in such underprovision is the availability of finance. Various estimates of the additional financing required for the expansion of infrastructure provision to support accelerated growth and development in the developing world are between $1.6 trillion and $2.0 trillion per annum by 2020.[19] The central issue, therefore, is how to finance the infrastructure needs of developing countries.

54. Private capital might be an important source of financing. However, infrastructure projects normally generate long-term social benefits that tend to be much greater than the private profits that may be captured by investors. Profit-seeking private firms thus have little incentive to invest in infrastructure and, when they do invest, concentrate on solvent market segments, which are normally not the most important for society. Private investment in infrastructure is held back by a number of factors, including perceived excessive risks by prospective investors. In addition, lenders cannot easily price risks due to a lack of sufficient information. Moreover, infrastructure projects are often long term, implying further risks and uncertainty. With regard to regional projects in particular, investors demonstrate an unwillingness to undertake such projects, as they are perceived as too complex due to, inter alia, coordination issues. These are familiar problems with the financing of public goods.

55. Multilateral and other development banks have played a leading role in providing finance for infrastructure projects and have the potential to further contribute to filling an important financing gap, in particular for developing regional infrastructure. They can address collective action and coordination problems (common in cross-border projects), given their accumulated knowledge and the availability of instruments.[20] Despite their advantages in the provision of finance for cross-border projects, however, they have in fact provided very little financing for such projects. According to one study, lending from three large regional development banks – African Development Bank, Asian Development Bank and Inter-American Development Bank – for regional public goods, including infrastructure projects, was less than 1 per cent of their total loans in the past.[21]

B. Lessons from successful experiences: European Investment Bank

56. The European Investment Bank has to an important extent been an exception in terms of loan provision for regional projects. This is partly as it was created with the explicit mandate to finance infrastructure to support regional integration at the level of the European Union. As a result, following its creation in the 1950s, the bank initially allocated 48 per cent – and later 44 per cent – of its total loans to infrastructure projects. A focus on infrastructure has permitted the bank to play a central role in the process of European integration. In addition, integration has been pursued in a broad sense, including the reduction of income differentials across Europe as a policy goal. Accordingly, financing strongly increases at the time of entry of new member countries, to help support the development of their less developed regions.[22]

[19] See for example A Bhattacharya, M Romani and N Stern, 2012, Infrastructure for development: Meeting the challenge, Policy Paper, Centre for Climate Change Economics and Policy.

[20] S Griffith-Jones, D Griffith-Jones and D Hertova, 2008, Enhancing the role of regional development banks, Intergovernmental Group of 24 Discussion Paper Series No. 50, UNCTAD.

[21] N Birdsall, 2006, Overcoming coordination and attribution problems: Meeting the challenge of underfunded regionalism, in: *The New Public Finance: Responding to Global Challenges*, I Kaul and P Conceicao, eds., Oxford University Press, Oxford.

[22] S Griffith-Jones, 2008.

57. The European Investment Bank is currently the largest multilateral lender, providing finance and expertise to further European Union policy goals. Over 90 per cent of its activity takes place in Europe. Strategic infrastructure is among the bank's current priorities. Essentially, it involves support for trans-European networks linking regional and national infrastructures in the areas of transport, information and communications technology and energy, in order to provide coherent network systems across Europe. This policy has, among others, the goal of promoting economic and social integration, the free movement of people, goods and services and competitive energy production and supply.

58. Most of the financing of the European Investment Bank is through loans, which often represent 30 per cent of the total financing of a project, though at times this share may reach 50 per cent. In addition, since the global crisis, the bank has played a vigorous countercyclical role, to help sustain income and investment levels across Europe and protect the region's infrastructure and productive capacity from the effects of the deep economic downturn. The Bank's role as financing provider is linked to a leveraging role, through blending resources from other financing sources, such as the European Union budget and the private sector, which has a large multiplier effect on the economy. The bank also plays the role of advisor, to provide assistance not only in areas of project financing but also in project design and management, to facilitate implementation and execution.[23]

C. How new financing institutions might change the landscape of financing for development in the near future

59. The successful experience of the European Investment Bank lends support to the notion that other multilateral development banks could be created to enhance regional integration in the developing world. Initiatives to design and set up such banks have been taken in recent years, such as the newly created New Development Bank and Asian Infrastructure Investment Bank.[24]

60. The creation of these banks seems timely, given both financing needs for infrastructure development, as elaborated in this note, and the amount of foreign reserves currently held by emerging economies. Such savings are partly placed in sovereign wealth funds and invested in low-yield assets in developed countries, and may be better employed in financing the infrastructure needs of the developing world, in addition to providing much higher returns.

1. New Development Bank

61. The New Development Bank was established to support infrastructure and sustainable development projects among the establishing States and other developing countries. Under this broad goal, the bank could actively support regional integration processes currently taking place in different parts of the world. Established with an initial authorized capital of $100 billion (and subscribed capital of $50 billion), the scope of the bank includes the mobilization of resources for infrastructure. As the bank is still in an initial phase of design, this scope may be expanded to include infrastructure for regional integration, so as to maximize the bank's developmental impact.

[23] European Investment Bank, 2015, see http://www.eib.org/about/index.htm (accessed 9 March 2015).
[24] The New Development Bank was established in July 2014 by Brazil, China, India, the Russian Federation and South Africa. The Asian Infrastructure Development Bank was established in Beijing in October 2014. Neither bank is in operation as yet.

62. The New Development Bank could help enhance interregional dialogue and cooperation. As such, its role is vital for forging closer ties among developing countries and countries with economies in transition, as well as with developed countries.

2. Asian Infrastructure Investment Bank

63. The Asian Development Bank estimates infrastructure financing needs in Asia at around $720 billion per annum, over the period 2010–2020. However, its annual loan approval level reaches only $13 billion.[25] There is thus a large financing gap for infrastructure in Asia.

64. The Asian Infrastructure Investment Bank was established to help fill this gap by providing finance for infrastructure projects in the Asia and Pacific region. In addition to national infrastructure projects, the bank aims to finance regional infrastructure projects that can support trade and further development of the region’s production networks.[26] The main funding mechanism will be the issuance of bonds in both regional and global markets.

65. Together with the New Development Bank, the Asian Infrastructure Investment Bank may be a driving force for the creation of an active network of development banks collaborating with each other, resulting in synergies and complementarities. The two banks may work closely with multilateral banks such as the World Bank, regional development banks such as the African Development Bank, Asian Development Bank and Inter-American Development Bank, subregional banks such as the Andean Development Corporation and various national development banks. Modalities of cooperation may include the co-financing of larger projects. Healthy competition and, most importantly, cooperation may thus create valuable externalities with other development financial institutions.

3. The possible role of non-bank financial initiatives

66. Financing for regional integration does not need to be bank based. Strengthening regional financial and monetary cooperation in forms other than by creating development banks might be another way forward in supporting integration. The Southern Common Market Structural Convergence Fund in South America and the Silk Road fund recently established by China are valuable examples of non-bank institutions created for this purpose.

67. The Structural Convergence Fund was created to enhance the integration of the Southern Common Market. Specifically, its establishment is aimed at financing programmes to support regional structural convergence, competitiveness and social integration among the South American countries belonging to the Southern Common Market.[27] The size of its funding has exceeded $1 billion in recent years, to be used mainly in the two smaller economies (Paraguay and Uruguay). The fund may play an important leveraging role when combined with other sources of financing, including from development banks.

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[25] DRO Junio, 2014, Asian Infrastructure Investment Bank: An idea whose time has come?, *The Diplomat*, 4 December.

[26] Ibid.

[27] Latin American and Caribbean Economic System, 2011, Opportunities, prospects and instruments for financing South-South cooperation in Latin America and the Caribbean, July, available at http://www.sela.org/attach/258/default/Documento_Final_Oportunidades,_perspectiva_e_instrumentos_(Sur-Sur)_6-7-11.pdf (accessed 20 April 2015).

68. The Silk Road fund consists of a newly established $40 billion fund to finance infrastructure projects to strengthen transport and other linkages between China and other Asian countries. Roughly 65 per cent of the fund is expected to come from China. Although the focus is on the creation of linkages in Asia, some analysts propose that this initiative could be extended to include African countries. The fund could benefit Africa by supporting both infrastructure and industrial development, as part of China's industrial relocation strategy.[28]

IV. Questions for discussion

69. Suggested questions for discussion include the following:

1) Under which conditions might trade become an engine of growth in a process of regional integration?

2) What is the best way to put in practice the concept of developmental regionalism?

3) Do GVCs change the development framework such that import substitution is no longer relevant for a typical developing country?

4) How are countries with economies in transition trying to promote regional productive integration?

5) What lessons in regional productive integration may be generated from the experiences of large economies (such as Brazil, China, India, the Russian Federation and South Africa) and which of them are perhaps not so relevant for smaller countries?

6) What policy lessons may be learned from successful experiences of financing regional integration?

7) How might new institutions such as the New Development Bank and Asian Infrastructure Investment Bank change the landscape of financing for development in the near future?

[28] JY Lin, 2015, Industry transfer to Africa good for all, *China Daily*, 20 January.