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South–South cooperation for trade, investment and structural transformation

Note by the UNCTAD secretariat*

Executive summary

Since the start of the millennium, growth across the South has been rapid but uneven and incomplete. Despite spurts of growth in trade, investments and financial flows among developing countries, structural transformation remains a formidable challenge. Taking as a point of departure a set of guiding questions received from member States, this note discusses South–South cooperation for trade, investment and structural transformation. South–South cooperation has been identified as a major means for facilitating structural transformation and implementation of the 2030 Agenda for Sustainable Development. To harness the full potential of South–South cooperation for structural transformation, however, there is a need for proactive policies at all levels, especially in the areas of trade, investment, finance and the digital economy. These include industrial policies to strengthen regional value chains, promoting regional development banks, encouraging investment policy coordination and harmonization and promotion of South–South digital cooperation at the regional level. Sharing of policy experiences can further release the catalytic potential of South–South growth.

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I. Introduction

1. South–South cooperation has been recognized as one of the means of implementing the 2030 Agenda for Sustainable Development.[1] It can contribute towards achievement of the Sustainable Development Goals and structural transformation of developing countries, including the least developed countries, and can help mitigate growing inequalities, both within and between countries. However, such cooperation is not a substitute for effective strategies of domestic resource mobilization or multilateral development support and cooperation.

2. The different areas of South–South cooperation, including trade, finance, technology and direct investments, have been on an upward trajectory thanks to emerging growth poles in the South and concerted efforts by policymakers to strengthen cooperation. South–South exports grew at an annual average rate of 13 per cent between 1995 and 2016, far outpacing the growth of world exports, at 8 per cent. Total foreign direct investment originating from developing countries has grown significantly, accounting for almost 30 per cent of global flows, with a majority of these investments going to other developing economies. These flows have also been accompanied by rising financial flows, mainly channelled through Southern regional banks.

3. Despite these growing South–South flows, developing countries still face an annual financing gap in the trillions of dollars to meet the Sustainable Development Goals.[2] Furthermore, growth in the South remains uneven, with many developing countries, and particularly the least developed countries, continuing to experience damaging economic shocks, volatile price movements, weak productive capacities, rising debts, lack of structural transformations and pervasive infrastructure deficits. Addressing these challenges will require further reforms to the wider multilateral architecture.

II. Opportunities and challenges of South–South cooperation in trade and investment

4. Since the mid-1990s, the share of the South in global output and trade has risen rapidly, with the value of South–South trade increasing seven-fold, from $0.6 trillion in 1995 to $4 trillion in 2016. This rise in South–South trade appears to provide new opportunities for the South. However, acceleration in the growth of output and trade has been concentrated in only a few developing countries, mainly in East Asia, with China contributing the most. Growth in East Asia, particularly in China, has spilled over to other developing countries in the form of increased demand for raw materials, which has contributed to South–South trade. Moreover, even where trade in manufactures has expanded, this has been linked to global supply chains, with the value added from export activities remaining low and the big gains enjoyed by headquarters activities.[3] In this new geography of production, developing economies with limited productive capacities risk remaining trapped in low value adding activities at the bottom of chains, which ultimately results in thin industrialization, weak productivity growth and growing income gaps.

5. Recognition of these difficulties has led many developing economies to seek opportunities under South–South cooperation that differ from the paths previously chosen. Greater emphasis is being placed on integrating trade with neighbouring countries through regional value chains. In parallel, new financing mechanisms for trade and infrastructure development have emerged that focus on building productive capacities and structural transformation at the regional level. Turning more towards regional markets in the South

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[1] General Assembly resolution 73/291, of 15 April 2019, Buenos Aires outcome document of the second High-level United Nations Conference on South–South Cooperation, annex.

[2] See UNCTAD, 2014, *World Investment Report 2014: Investing in the [Sustainable Development Goals] – an Action Plan* (United Nations publication, Sales No. E.14.II.D.1, New York and Geneva).

[3] UNCTAD, 2018, *Trade and Development Report 2018: Power, Platforms and the Free Trade Delusion* (United Nations publication, Sales No. E.18.II.D.7, New York and Geneva), pp. 44–45.

may help generate economies of scale, create employment and foster diversification and production upgrading. By undertaking more high value adding activities within a region, regional value chains offer opportunities to move up the value added ladder and accelerate transformation.

6. South–South investment flows can also play an instrumental role in advancing the Sustainable Development Goals. For developing host economies, foreign direct investment from other developing countries can provide a broad range of potential sources of capital, technology and management skills, suggesting a greater likelihood of beneficial linkages and technology absorption. However, South–South foreign direct investment also carries risks, which include crowding-out effects, market dominance issues and, in some cases, lower labour and environmental standards. In some developing host countries, these problems are exacerbated by the absence of an adequate regulatory framework.

7. To boost South–South investment and magnify its development impact, efforts need to be made by both home and host countries. Home countries can encourage and facilitate outward investment towards other developing economies. For example, in relevant sectors of the Sustainable Development Goals, improvements can be made through targeted credit or insurance programmes to encourage investment in agriculture and rural development, manufacturing, infrastructure, sustainable energy and regional value chain development. At the same time, home countries need to implement measures that encourage responsible investment behaviours of resident international companies and ensure spillovers are leveraged in support of domestic production. Ensuring sufficient policy space will be key to building on the advantages offered by heightened South–South integration.

8. Many of the challenges arising from closer integration cannot be addressed by national policies alone. South–South cooperation at the regional and international levels plays an instrumental role, particularly in investment policy coordination and harmonization. The UNCTAD Investment Policy Framework for Sustainable Development and its action plan for investing in the Sustainable Development Goals provide a useful policy framework for South–South cooperation that leverages cross-border investment and magnifies the impact on sustainable and inclusive development.

III. Strengthening financial and economic sustainability in the context of South–South cooperation

9. Rising inequality around the world in the past 30 years or so has had many causes, but a central one affecting developing countries with special intensity is inequality arising from financial instability and crises.[4] To the extent that developing countries have pursued external financial liberalization and attracted international private capital to finance their economies, they have become vulnerable to volatile private capital and to high levels of external indebtedness. In parallel with this trend, South–South financial cooperation has been reinvigorated since the beginning of the twenty-first century, with the consequent emergence of a new Southern development finance landscape.

10. Developing country Governments might feel tempted to finance the public investment projects needed to support structural transformation by tapping into international private financial markets, particularly when fiscal space is constrained. A perceived advantage of this type of financing source is the speed with which resources might be made available and the fact that they do not come with policy conditionality attached, as is usually the case with official finance provided by multilateral financial institutions. This policy choice, however, carries significant risks. One main risk is that, as economic pressures in a lending country tend to drive flows from international private financial markets, these flows have short-term horizons and interest rates that reflect perceived country risk. The result can be highly volatile flows.

[4] UNCTAD, 2017, *Trade and Development Report 2017: Beyond Austerity – Towards a Global New Deal* (United Nations publication, Sales No. E.17.II.D.5, New York and Geneva).

11. Financial assistance from South–South cooperation, on the other hand, typically involves financial resources from public development banks and agencies of partner countries. These banks and agencies often provide such resources on better terms and conditions, and they target developmental projects. Bank and agency technical staff scrutinize the financial and developmental soundness of the projects they support. Under this form of finance, one risk is that, though individual projects may be appropriately scrutinized, partner countries do not necessarily pay adequate attention to a country's aggregate debt situation and, therefore, its capacity to service the debt. Against this concern, it is worth noting that, in the context of the Belt and Road Initiative, China has recently begun to consider a country's overall debt capacity when taking investment and financing decisions to ensure debt sustainability.[5] Thus, whatever choices developing countries make regarding how to finance investment projects, the challenge they face is to know how best to manage the risks involved so that external finance can be harnessed to maximum effect in support of structural transformation and the achievement of the Sustainable Development Goals.

IV. South–South digital cooperation for structural transformation

12. The advent of "Industry 4.0" has created new opportunities for the South to structurally transform economies but has also added new development challenges. It offers the opportunity to developing countries to upgrade in global value chains by using digital technologies and digital services, which can increase the value of their exports. The gains of digitalization, however, are not automatic. There is a risk that digitalization will lead to further polarization and widening of income inequalities as various digital divides come into play, including in the access and use of information and communications technologies, notably between rich and poor and across and within countries. A precondition for developing countries to be able to grasp the rising opportunities in the digital world is to define sound policies with respect to ownership of data generated within a country's territory and to build its digital infrastructure, as well as put in place the required digital capabilities. South–South cooperation can play an important role in helping the South to digitally industrialize and build capacity to gain from the digital revolution, which can assist in a country's structural transformation.

13. UNCTAD has proposed a 10-point progressive South–South digital cooperation agenda for industrialization and regional integration,[6] which can be implemented at the regional and subregional levels in the South. This agenda can help developing countries build their digital capacities and digital infrastructure with regional support and through North–South partnerships. The agenda includes building a data economy; building cloud computing facilities; strengthening broadband infrastructure; promoting electronic commerce in the region; promoting regional digital payments; making progress on a single digital market in the region; sharing experiences on e-government; forging partnerships for building smart sustainable cities; promoting digital innovations and technologies; and building statistics for measuring digitalization.

[5] See W Hongyuran and F Wang, 2019, Central bank Chief says China will guard against Belt and Road debt risks, *Caixin Global*, available at https://www.caixinglobal.com/2019-04-25/central-bank-chief-says-china-will-guard-against-belt-and-road-debt-risks-101408561.html (accessed 6 May 2019).

[6] See UNCTAD, 2018, *South–South Digital Cooperation for Industrialization: A Regional Integration Agenda* (United Nations publication, New York and Geneva) and UNCTAD, 2018, *Forging a Path Beyond Borders: The Global South* (United Nations publication, Sales No. E.19.II.D.2, Geneva).

V. Sharing of policy experiences on structural transformation in the South

14. Developing countries have demonstrated better growth performance since the turn of the millennium, but they still face multiple challenges in their structural transformation, which calls for appropriate policy response at all levels. However, designing effective and development-friendly policy formulation requires local knowledge, experience and strong capacity. In this regard, sharing of experiences and capacity-building have become increasingly important, as they can improve the policymaking capabilities of developing countries.

15. While most developing countries are still struggling with their respective development challenges, some countries in the South have made rapid progress. Notably, China has recorded an average annual gross domestic product growth rate of 9.5 per cent since 1978, shifted its economic structure away from rural activities and lifted over 700 million people out of poverty. While having reached middle-income status, China remains a developing country and, as such, other countries in the South can draw lessons from its experience on the successful employment of development policies. In this context, the Belt and Road Initiative of China provides an opportunity to facilitate the sharing of policies and experience among over 100 of the Initiative's partner countries. UNCTAD has launched a Belt and Road Initiative platform[7] for sharing of experiences, capacity-building and shaping of policy in the areas of industrial growth, trade, macroeconomic environment, development finance, debt management and the digital economy. The platform could make a significant contribution to fostering a development-friendly policy environment and achieving the 2030 Agenda for Sustainable Development in the South.

VI. Policy recommendations

16. Growth in the South has been uneven and incomplete. Developing countries are facing multiple challenges in their structural transformation and in the pursuit of a new and ambitious sustainable development agenda. This calls for appropriate policy responses at all levels. South–South cooperation can help developing countries make the most of vibrant South–South trade, finance, investment and technology for sustainable development. This note has presented some of the policies to address these challenges. The Trade and Development Board may wish to consider the following policy recommendations:

(a) South–South cooperation is needed to support building productive capacity and structural transformation in the South. Governments could consider strategic engagement within their regions in order to promote regional value chains which can drive product upgrading and export diversification. New financing mechanisms for trade and infrastructure development in the region need to be put in place.

(b) South–South cooperation at the regional and international levels can play a pivotal role in investment policy coordination and harmonization. In this regard, member States may wish to consider the UNCTAD Investment Policy Framework for Sustainable Development and its action plan for investing in the Sustainable Development Goals as a useful policy framework for South–South cooperation that leverages cross-border investment for sustainable and inclusive development.

(c) Given the large financing gap for the attainment of the 2030 Agenda for Sustainable Development, Governments may wish to consider strengthening financial assistance to Southern regional banks to build foundations for providing pragmatic options to address Southern financial concerns within the global system.

[7] See https://unctad.org/en/Projects/BRI-Platform/Pages/index.aspx (accessed 6 May 2019).

(d) Developing countries will not be able to digitally leapfrog on their own. They will need support at both the regional and international levels. In this regard, member States may wish to consider the role of the UNCTAD South–South digital cooperation agenda for industrialization and regional integration as a policy framework at the regional level to promote digital industrialization, regional integration and structural transformation in the South.

(e) Strategies and policies are context and time specific, but there are overarching principles that can enhance the quality and effectiveness of the policy process. Governments may wish to consider the role played by the UNCTAD Belt and Road Initiative platform in terms of institutionalizing the sharing of knowledge and policy experiences among developing countries.