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**UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT**  
**GENEVA**

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# **TRADE AND DEVELOPMENT REPORT, 2007**

Report by the secretariat of the  
United Nations Conference on Trade and Development



**UNITED NATIONS**  
New York and Geneva, 2007

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UNCTAD/TDR/2007

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| UNITED NATIONS PUBLICATION               |
| <i>Sales No. E.07.II.D.11</i>            |
| ISBN 978-92-1-112721-8<br>ISSN 0255-4607 |

## FOREWORD

Over the past five years, the expansion of the world economy and trade has served as an engine of growth for many developing countries and helped to support progress to the Millennium Development Goals. Even the poorest countries have been able to reap benefits from sustained growth of the world economy, largely because of favourable price developments in many primary commodities. Thus the global external environment for development has strongly improved since the turn of the Millennium.

But as the *Trade and Development Report 2007* points out, this beneficial environment has some unsettling features, such as persistent imbalances and net capital flow from developing to developed countries. If we are to avert serious negative repercussions for economic growth and development, major deficit and surplus countries must work together to address these issues.

For developing countries, the most important challenge is to translate recent gains into lasting progress through successful integration into the global economy. Appropriate policies at the national level are crucial. So are efforts to bring multilateral trade negotiations to a successful conclusion, with a strengthened development dimension in international trade rules. But at the regional level, too, collective and coordinated responses can offer additional possibilities for improving growth and structural change in the globalizing world. By working together more closely and building on common and complementary interests, partners in the same geographical region can significantly strengthen their efforts to meet the challenges of globalization. The *Trade and Development Report 2007* examines the role that such cooperation can play.

In recent years, policymakers in developing countries have paid increasing attention to regional cooperation and integration in support of national development efforts. The assessments and policy proposals presented in this *Trade and Development Report* are likely to meet with considerable interest, and make a valuable contribution to the debate on how best to make regional cooperation work for development.

Ban Ki-moon  
Secretary-General of the United Nations



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## Explanatory notes

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### Classification by country or commodity group

The classification of countries in this *Report* has been adopted solely for the purposes of statistical or analytical convenience and does not necessarily imply any judgement concerning the stage of development of a particular country or area.

The major country groupings used in this *Report* follow the classification by the United Nations Statistical Office (UNSO). They are distinguished as:

- » Developed or industrial(ized) countries: the countries members of the OECD (other than Mexico, the Republic of Korea and Turkey) plus the new EU member countries and Israel.
- » The category South-East Europe and Commonwealth of Independent States (CIS) replaces what was formerly referred to as “transition economies”.
- » Developing countries: all countries, territories or areas not specified above.

The terms “country” / “economy” refer, as appropriate, also to territories or areas.

References to “Latin America” in the text or tables include the Caribbean countries unless otherwise indicated.

References to “sub-Saharan Africa” in the text or tables include South Africa unless otherwise indicated.

For statistical purposes, regional groupings and classifications by commodity group used in this *Report* follow generally those employed in the *UNCTAD Handbook of Statistics 2006–07* (United Nations publication, sales no. E/F.07.II.D.2) unless otherwise stated.

### Other notes

References in the text to *TDR* are to the *Trade and Development Report* (of a particular year). For example, *TDR 2006* refers to *Trade and Development Report, 2006* (United Nations publication, sales no. E.06.II.D.6).

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

The term “billion” signifies 1,000 million.

The term “tons” refers to metric tons.

Annual rates of growth and change refer to compound rates.

Exports are valued FOB and imports CIF, unless otherwise specified.

Use of a dash (–) between dates representing years, e.g. 1988–1990, signifies the full period involved, including the initial and final years.

An oblique stroke (/) between two years, e.g. 2000/01, signifies a fiscal or crop year.

A dot (.) indicates that the item is not applicable.

Two dots (..) indicate that the data are not available, or are not separately reported.

A dash (-) or a zero (0) indicates that the amount is nil or negligible.

A plus sign (+) before a figure indicates an increase; a minus sign (-) before a figure indicates a decrease.

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

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## Abbreviations

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|         |   |
|---------|---|
| ACP     | African, Caribbean and Pacific (group of countries)     |
| ADB     | Asian Development Bank                                  |
| AfDB    | African Development Bank                                |
| CAFTA   | Central American Free Trade Area                        |
| CIS     | Commonwealth of Independent States                      |
| COMECON | Council for Mutual Economic Assistance (or CMEA)        |
| EC      | European Commission                                     |
| ECA     | Economic Commission for Africa                          |
| ECE     | Economic Commission for Europe                          |
| ECLAC   | Economic Commission for Latin America and the Caribbean |
| ECSC    | European Coal and Steel Community                       |
| EEC     | European Economic Community                             |
| EMU     | European Economic and Monetary Union                    |
| EPA     | economic partnership agreement                          |
| EU      | European Union  |
| EURATOM | European Atomic Energy Community                        |
| FDI     | foreign direct investment                               |
| FTA     | free trade agreement                                    |
| GATS    | General Agreement on Trade in Services                  |
| GATT    | General Agreement on Tariffs and Trade                  |
| GDP     | gross domestic product                                  |
| GNP     | gross national product                                  |
| IDB     | Inter-American Development Bank                         |
| IMF     | International Monetary Fund                             |
| IP      | intellectual property                                   |
| IPR     | intellectual property right                             |
| ISIC    | international standard industrial classification        |
| IT      | information technology                                  |
| LIBOR   | London interbank offered rate                           |
| MDG     | Millennium Development Goal                             |

|             |  |
|-------------|--|
| MFN         | most-favoured nation   |
| NIE         | newly industrializing economy  |
| ODA         | official development assistance  |
| OECD        | Organisation for Economic Co-operation and Development                       |
| PPP         | purchasing power parity  |
| PTA         | preferential trade agreement   |
| R&D         | research and development   |
| REER        | real effective exchange rate   |
| RTA         | regional trade agreement   |
| SDR         | special drawing right  |
| SME         | small and medium-sized enterprise  |
| TDR         | Trade and Development Report   |
| TNC         | transnational corporation  |
| TRIMs       | trade-related investment measures (also a WTO Agreement)                     |
| TRIPS       | trade-related aspects of intellectual property rights (also a WTO Agreement) |
| UN COMTRADE | United Nations Commodity Trade Statistics Database                           |
| UN/DESA     | United Nations Department of Economic and Social Affairs                     |
| UNCTAD      | United Nations Conference on Trade and Development                           |
| WIR         | World Investment Report  |
| WTO         | World Trade Organization   |

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## List of regional blocs and membership

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|                |   |
|----------------|---|
| AFTA           | <a href="#">ASEAN Free Trade Area</a><br>ASEAN member States  |
| ANCOM          | <a href="#">Andean Community of Nations (Comunidad Andina de Naciones)</a><br>Bolivia, Colombia, Ecuador, Peru, Venezuela (Bolivarian Republic of) (until 2006)   |
| ASEAN          | <a href="#">Association of Southeast Asian Nations</a><br>Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, Viet Nam   |
| ASEAN+3        | <a href="#">Association of Southeast Asian Nations +3</a><br>ASEAN plus China, Japan and the Republic of Korea  |
| CACM           | <a href="#">Central American Common Market (Mercado Común Centroamericano)</a><br>Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua   |
| CARICOM        | <a href="#">Caribbean Community</a><br>Antigua and Barbuda, Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Haiti, Jamaica, Montserrat, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, Suriname, Trinidad and Tobago   |
| CEMAC          | <a href="#">Economic and Monetary Community of Central Africa (Communauté Economique et Monétaire de l'Afrique Centrale)</a><br>Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea, Gabon   |
| CFA franc zone | <a href="#">Coopération Financière en Afrique Centrale/Communauté Financière Africaine</a><br>CEMAC and UEMOA member States   |
| CIS            | <a href="#">Commonwealth of Independent States</a><br>Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Republic of Moldova, Russian Federation, Tajikistan, Turkmenistan, Ukraine, Uzbekistan   |
| CMA            | <a href="#">Common Monetary Area</a><br>Lesotho, Namibia, South Africa, Swaziland   |
| COMESA         | <a href="#">Common Market for Eastern and Southern Africa</a><br>Angola, Burundi, Comoros, the Democratic Republic of the Congo, Djibouti, Egypt, Eritrea, Ethiopia, Kenya, the Libyan Arab Jamahiriya, Madagascar, Malawi, Mauritius, Rwanda, Seychelles, Sudan, Swaziland, Uganda, Zambia, Zimbabwe |
| EAC            | <a href="#">East African Community</a><br>Kenya, the United Republic of Tanzania, Uganda  |
| ECCAS          | <a href="#">Economic Community of Central African States</a><br>Angola, Burundi, Cameroon, Central African Republic, Chad, Congo, the Democratic Republic of the Congo, Equatorial Guinea, Gabon, Rwanda, São Tomé and Príncipe   |
| ECCU           | <a href="#">Eastern Caribbean Currency Union</a><br>Anguilla, Antigua and Barbuda, Dominica, Grenada, Montserrat, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines  |
| ECO            | <a href="#">Economic Cooperation Organization</a><br>Afghanistan, Azerbaijan, Iran (Islamic Republic of), Kazakhstan, Kyrgyzstan, Pakistan, Tajikistan, Turkey, Turkmenistan, Uzbekistan  |
| ECOWAS         | <a href="#">Economic Community of West African States</a><br>Benin, Burkina Faso, Cape Verde, Côte d'Ivoire, Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Niger, Nigeria, Senegal, Sierra Leone, Togo   |

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|          |   |
|----------|---|
| EU-15    | <a href="#">European Union-15</a><br>Austria, Belgium, Denmark, Germany, Greece, France, Finland, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, the United Kingdom  |
| EU-25    | <a href="#">European Union-25</a><br>EU-15 plus Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia  |
| EvrAzES  | <a href="#">Eurasian Economic Community</a><br>Belarus, Kazakhstan, Kyrgyzstan, the Russian Federation, Tajikistan and Uzbekistan   |
| EU       | <a href="#">European Union</a><br>EU-25 plus Bulgaria and Romania   |
| GCC      | <a href="#">Gulf Cooperation Council</a><br>Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates  |
| IOC      | <a href="#">Indian Ocean Commission</a><br>Comoros, Madagascar, Mauritius, Reunion (France), Seychelles   |
| LAIA     | <a href="#">Latin American Integration Association (Asociación Latinoamericana de Integración)</a><br>Argentina, Bolivia, Brazil, Cuba, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay, Venezuela (Bolivarian Republic of)                     |
| MERCOSUR | <a href="#">Southern Common Market (Mercado Común del Sur)</a><br>Argentina, Brazil, Paraguay and Uruguay   |
| NAFTA    | <a href="#">North American Free Trade Agreement</a><br>Canada, Mexico, United States  |
| OECS     | <a href="#">Organisation of Eastern Caribbean States</a><br>ECCU plus British Virgin Islands  |
| SAARC    | <a href="#">South Asian Association for Regional Cooperation</a><br>Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, Sri Lanka   |
| SACU     | <a href="#">Southern African Customs Union</a><br>Botswana, Lesotho, Namibia, South Africa, Swaziland   |
| SADC     | <a href="#">Southern African Development Community</a><br>Angola, Botswana, the Democratic Republic of the Congo, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, South Africa, Swaziland, the United Republic of Tanzania, Zambia, Zimbabwe |
| SAFTA    | <a href="#">South Asian Free Trade Agreement</a><br>SAARC member States   |
| UEMOA    | <a href="#">West African Economic and Monetary Union (Union Economique et Monétaire Ouest Africaine)</a><br>Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, Togo   |
| UMA      | <a href="#">Arab Maghreb Union</a><br>Algeria, the Libyan Arab Jamahiriya, Mauritania, Morocco, Tunisia   |
| WAMZ     | <a href="#">West African Monetary Zone</a><br>Gambia, Ghana, Guinea, Nigeria, Sierra Leone  |



## OVERVIEW

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### **Global economic trends envisage a continued expansion of the world economy**

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In 2007, for the fifth consecutive year, the expansion of the world economy is expected to maintain its momentum with an estimated overall output growth of 3.4 per cent. Thus developing countries, including many of the poorest, should continue to benefit from strong demand for primary commodities. In many developing countries, including in Africa, positive trends in the terms of trade since 2003 have contributed to improved external and fiscal balances. These have paved the way for more expansionary policies, and for a widespread recovery in investment rates. Africa is set to continue growing at around 6 per cent in 2007, while growth rates in Latin America and West Asia are expected to slow down slightly to close to 5 per cent. Indeed, over the past five years, per capita GDP in Africa, West Asia and Latin America has increased by more than 15 per cent, a rate not seen in these regions since the early 1980s. This certainly raises hopes for greater progress towards meeting the United Nations Millennium Development Goals. However, it has to be noted that not all developing countries have experienced improvements in their terms of trade, because they have to contend with higher oil import bills while the prices of the products they export have not increased at similar rates.

Once again, the fastest growing regions of the world economy will be East and South Asia, due mainly to the strong performances of China and India. Given their high investment ratios, this pattern is likely to continue in the years to come, provided that the inevitable correction of global imbalances does not occur at the expense of a major recession in the United States, one of the largest markets for Asian exports. There are some signs of a slight shift in the sources of world economic growth, with the United States economy slowing down and domestic demand in Europe and Japan recovering.

The performance of developing countries and their potential for catching up with the developed countries has improved considerably. Although enormous differences in absolute incomes persist, developing countries increased per capita GDP by almost 30 per cent between 2003 and 2007, compared to 10 per cent in the G-7 countries. Real per capita income has picked up in recent years in Latin America, Africa and West Asia after more than two decades of stagnation. In East and South Asia economic growth accelerated from already high growth rates, which allowed these subregions to more than double their per capita GDP in only 14 years. The transition economies of South-East Europe and the CIS returned to growth in 1999–2000. Since then, they have been the most rapidly growing subregions, with an accumulated increase in per capita income of almost 75 per cent. However, this

recovery has come after such a deep depression that current per capita GDP is still below its level of 1989. In 2007, six years after the start of global recovery, less than 10 out of 143 developing countries are set to record a fall in real per capita income. At the same time, the volatility of growth has declined to levels normally observed only in highly developed economies.

In this favourable external economic climate, most developing economies have seen strong growth in employment or have succeeded in stabilizing or slightly reducing unemployment rates, and this despite the fact that open unemployment in developing countries is much less responsive to high growth rates than it is in developed countries. The unemployment rate has fallen visibly only in Latin America. In Asia, where the level of unemployment varies considerably among the different subregions, the rates have remained more or less stable, while sub-Saharan Africa has seen a minor decline. The main reason for the low impact of growth on open unemployment in many developing countries and emerging market economies could be the huge reserves of labour that enter the formal economy only after a longer phase of rising demand for labour and increasing wages. As some emerging countries – including China – show, the process of integrating such reserves of labour into more formal labour markets may take many years of fast growth. But if the gains of strong productivity growth spread equally to wage earners and to companies, the resulting consumption boom should further stimulate growth and enhance the opportunities for low-paid workers in the informal economy to find decent employment in the formal economy.

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### **Growing exports and net capital outflows from developing countries**

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The dynamics of overall growth in developing countries have been stimulated by strong growth in export revenues. Real exports of developing economies more than doubled between 1998 and 2006, whereas those of the G-7 rose by less than 50 per cent. Among the developing regions, East and South Asia were clearly the most successful in increasing exports (by volume), at a rate of about 160 per cent, despite a deterioration in their terms of trade. In other developing regions, export volumes grew at a more moderate pace, close to that of the G-7, but gains from the terms of trade boosted the purchasing power of their exports, and consequently their imports. Overall, the share of developing countries in global trade rose from 29 per cent in 1996 to 37 per cent in 2006.

As a consequence of this favourable trade performance, the overall current account of developing countries has swung into a surplus for the first time since the early 1970s, and that of developed economies is in deficit, mainly due to the huge deficit of the United States. This positive swing could be observed in most developing regions and in the transition economies. For example, in 1996–1997, South America, South-East Asia and the transition economies posted significant deficits, and East Asia and West Asia were close to balance; all of them now have solid current-account surpluses.

As a result, a number of developing countries have become net exporters of capital on such a scale that there has been a net aggregate capital outflow from developing countries. But this has not been a constraint on domestic capital formation. Indeed, while real investment in the G-7 countries remained rather flat (and investment/GDP ratios declined), many developing economies were able to trigger an investment recovery once their financial crises were overcome. The sustained net capital exports from the poorer developing countries to the capital-rich developed countries raises doubts

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about the validity of orthodox development theory in the new global context, and points to the need for a rethinking of the most crucial assumptions about the functional relationships between savings, investment, capital flows and alternative policies and catch-up paths.

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## Global imbalances still awaiting a solution

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The sources, sustainability and possible adjustment of the widening imbalances in the world economy have triggered one of the liveliest and more controversial economic policy debates of the past few decades. For some observers and politicians, the fact that imbalances correspond to a real transfer of resources from surplus to deficit countries is just a natural and harmless consequence of an increasingly integrated global economy.

Others believe that the size of any transfer of resources, be it to individuals or to nations, should remain reasonably related to the expected long-run ability of individuals or nations to pay interest and amortization. Therefore the substantial net capital flows in one direction over many years is indicative of a fundamental problem with the allocation of capital in the world economy since the aftershocks of the big financial crises in Asia, Latin America and some transition economies. From this perspective, adjustment is imminent and can be either “soft”, involving a smooth correction through government intervention, or “hard”, involving a painful contraction and crisis in deficit countries with major adverse repercussions for surplus countries.

Undoubtedly, the overall competitiveness of an economy that runs a persistent deficit or surplus is a decisive factor influencing the sustainability of the trade or current-account balance. Indeed, in the past, large corrections of deficits usually went hand in hand with huge devaluations of the nominal and real values of the currencies affected. Empirical evidence has shown that changes in the real effective exchange rate (REER), the most comprehensive measure of the overall competitiveness of countries, have the potential to reduce deficits or to cause swings in the trade and current account from deficit to surplus, because they induce an expenditure switch between demand for domestic and foreign goods.

Thus an increasing current-account surplus accompanied by a real devaluation (i.e. a “false” price movement) must be taken as a much stronger indication of non-sustainability than a surplus accompanied by a tendency towards real appreciation. The Japanese yen, for example, rather than appreciating as could be expected due to the strong Japanese competitive position and a huge current-account surplus, has depreciated in recent years – in both nominal and real terms – vis-à-vis the currencies of Japan’s major trading partners, thereby further increasing the competitiveness of Japanese exporters. And there are other cases where exchange-rate changes have moved in a wrong direction. Indeed, compared to 1996, of all the world’s large economies and countries with the biggest surpluses, only China has experienced a slight appreciation of its REER, and thus a slight deterioration in its competitive position. In the other three countries with the largest surpluses – Japan, Germany, and Switzerland in particular – which are all officially adhering to “free floating” regimes, the real value of their currencies has actually fallen (their competitiveness has increased), further lowering the prices of their products on the world market.

This paradox deserves greater attention than has hitherto been accorded in the debate about remedies for global imbalances, even if the reasons for the real depreciation of currencies vary. In

Germany, the real depreciation compared to the mid-1990s can be attributed to very slow growth in nominal wages. This has driven unit labour costs lower than the levels of its main trading partners, both inside and outside the euro area, despite an appreciation of the euro against the dollar. In the case of the yen and the Swiss franc, their real depreciation can be explained by so-called “carry trades”, which occur when there are large differences between the expected nominal return and the real return on investments.

This is not a new phenomenon: most of the financial crises in the post-Bretton Woods era of floating currencies were preceded by a build-up of nominal interest rate differentials, which were not covered by immediate depreciation (so-called uncovered interest rate speculation). What is new is that big institutional portfolio investors like hedge funds are able to trigger a long-lasting appreciation in the real exchange rate of a country with a higher nominal interest rate, and thereby increase the return on their investments through their own behaviour. Moreover, if central banks attempt from the outset to limit the extent of appreciation of the domestic currency through intervention in the foreign-exchange market, the resulting growing stock of foreign currency reserves only reduces the risk for international speculators.

The ongoing carry trade from yen or Swiss francs – currencies of countries with very low inflation and very low nominal interest rates – to countries with higher inflation and higher interest rates like Brazil, New Zealand or Hungary breaks the vital link between interest rate differentials (and inflation rate differentials) and the risk of currency depreciation, a link that is crucial for the long-term equilibrium of the global trading system. If the financial markets systematically distort the competitive positions of nations and companies, policy intervention is unavoidable, sooner or later. Unhedged borrowing by hedge funds and other speculators raises the question as to whether a floating regime is the only feasible solution to the problem of the external balance and a buffer against external shocks.

In this context, political pressure on China to float its currency may be counterproductive. Floating of the Chinese currency may yield exactly the opposite of the expected result. As China’s interest rates are still rather low, the renminbi could follow the examples of the yen and Swiss franc, with Chinese assets being carried to high interest rate locations. This would result in a depreciation of the renminbi, which would further increase China’s competitiveness instead of reducing it – an outcome that would worsen global imbalances even more.

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## External regimes and fixed investment

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Large returns on uncovered interest rate speculation penalize international competitiveness and capital formation through two channels: the real exchange rate and the real interest rate. Empirical evidence shows that the existence of uncovered interest returns (i.e. returns that carry the risk of exchange-rate changes) tends to reduce international competitiveness and increases the cost of capital for domestic investors in fixed capital.

Only a few countries – Japan and Switzerland being outstanding examples – can afford largely to ignore changes in the exchange rate and keep nominal (and real) interest rates at a very low level without the risk of accelerating inflation. However, this behaviour induces high margins in speculation with uncovered returns, and it provokes the real appreciation of currencies elsewhere. In the case of

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Japan, this is due to the deflationary risks that are fuelled by very low or negative growth rates of wages. The open capital market and the extremely low interest rate invite speculation to drive the yen down and other currencies up.

For Brazil, Mexico, South Africa, Turkey and Hungary, countries which have recently adopted inflation targets for monetary policy that typically require a free floating currency and control of the inflation rate through interest rates, the results have been disappointing. Although the post-devaluation regime usually marked a deep structural change for these countries, with a shift towards more credible monetary policies, interest rates and volatility are still very high, and the tendency towards real appreciation and deterioration in overall competitiveness persists. Additionally, the high real interest rate, systematically higher than in the United States or other large industrialized countries, constrains capital accumulation and catch-up.

For middle-income Asian countries, such as Indonesia, Thailand and the Republic of Korea, the regime change from soft peg to float following their crises has also been associated with larger exchange-rate volatility and a tendency towards real appreciation. Only China, with its specific pattern of strict intervention in the currency market to fix the exchange rate and negative real interest rates, has succeeded in maintaining a high degree of stability and very low costs of capital, which is extremely favourable to the creation of capital through fixed investment.

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## Policy options

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For small open economies, and developing countries in particular, a stable and prospering external sector is crucial, which is why the exchange rate is the most important single price in these economies: it influences overall competitiveness and has a strong impact on national price levels. To avoid the fight for market shares through manipulation of exchange rates, wage rates, taxes or subsidies, and to prevent the financial markets from driving the competitive positions of nations in the wrong direction, the globalized economy may need a new code of conduct to govern overall competition between nations.

Such a code of conduct, as part of the global governance system, would have to balance the advantages of one country, accruing from a constellation of changes in real exchange rates, against the disadvantages of others that are directly or indirectly affected. For example, changes in the nominal exchange rate that deviate from the fundamentals, and which do not merely reflect inflation differentials, affect international trade in a similar way as changes in tariffs and export subsidies. Consequently, changes in the real exchange rate should be subject to multilateral oversight and disciplines. Reasons for a deviation from the fundamentals and the necessary dimension of the deviation could be identified. If appropriate exchange-rate rules were established, unjustified losses or gains in overall competitiveness could be prevented. Developing countries could thereby systematically avoid overvaluation, which has been one of the greatest impediments to sustained prosperity in the past.

In the absence of such an arrangement, developing countries need flexibility for managing their exchange rates and a sufficient number of instruments to prevent excessive volatility in the external sector in order to improve their prospects for long-term investment and successful catching up. Empirical evidence belies the orthodox belief that with free-floating regimes international financial markets can

do that job by smoothly adjusting exchange rates to their “equilibrium” level, and that with fixed exchange rates, product, financial and labour markets would always be flexible enough to smoothly and rapidly adjust to a new equilibrium. In reality, exchange rates under a floating regime have proved to be highly unstable, leading to long spells of misalignment, with disastrous consequences for the real economic activity of the economies involved. The experience with hard pegs has not been satisfactory either; since it has not been possible to correct the exchange rate in response to external shocks or misalignment, adjustments have been costly in terms of lost output, and the real sectors of the domestic economy have borne the brunt.

A strategy of providing policy space and control over the relevant monetary instruments can only be replaced by multilateral oversight and surveillance if the leading industrialized economies are willing to play a more proactive role in steering the international monetary system, including through direct intervention, to enable orderly depreciations for countries in trouble. Past experience has demonstrated that developing countries with strong current-account positions are able to avoid destabilizing capital inflows and outflows either by taxing those flows or by limiting their impact through direct intervention in the market. In these cases, the hardest choices and the gravest misallocations due to erratic exchange-rate changes have been avoided. But neither the resort to controls nor to permanent intervention can be a substitute for an appropriate exchange-rate system at the regional or – preferably – the global level.

In light of the dim prospects for such a solution at the global level, initiatives for monetary cooperation at the regional level have received increasing attention in recent years. On the one hand, this is a reaction to the gaps between the original ideas and the actual outcome concerning the reform of the international financial architecture; on the other hand, it is also part of the broader trend towards “regionalism” aimed at strengthening national development strategies.

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## Globalization and regionalization

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Regional cooperation among developing countries has the potential to support national development strategies, and to some extent fill the gaps in the global economic governance system. But in order to do so it has to extend beyond trade liberalization to include policy areas that strengthen the potential for growth and structural change in developing countries. These include macroeconomic and financial management, as well as trade support and industrial policies. There appears to be an untapped potential for closer regional cooperation among developing countries in these areas, which could also add policy options to those available at the national level. On the other hand, the trend towards North-South bilateral or regional trade agreements, resulting from a sense of frustration of some governments with the slow progress in multilateral trade negotiations and an attempt to advance liberalization in areas that are not subject to these negotiations, threatens the coherence of the multilateral trading system. It also threatens the viability of existing regional cooperation arrangements among developing countries, and, most importantly, the options available to these countries for pursuing their national development strategies.

Economic integration within a national economy is 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 national institutions are also required to forge the socio-political consensus needed to mobilize and channel resources into productive investment and to manage the trade-offs incurred along a dynamic development path, including those arising from increased external integration. Developing countries seek to integrate into the world economy in the expectation that this will help accelerate output growth and productivity and improve living standards through increased trade, technology and capital flows. In order to be able to derive such benefits from external integration, similar conditions have to be fulfilled as for internal integration: they must have a certain level of local production capacity, skills and technological sophistication, an array of market supporting institutions and good infrastructure.

But with the increasing interdependence of national economies in a globalizing world, national development increasingly depends on the external environment and on coherent structures in the international monetary and financial systems. Last year's *Trade and Development Report* 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. And, as suggested above, new multilateral disciplines are necessary, particularly in the area of international finance, to achieve more balanced outcomes. 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.

Regional economic cooperation occurs in various forms and degrees, and is in general aimed at increasing cross-border linkages and deepening interpenetration of economic activity for the mutual

benefit of economies within a geographic region. A distinction is frequently made between policy-induced integration, which is also called regionalism and involves formal economic cooperation arrangements, and market-driven integration, also termed regionalization, which is spurred by regional growth dynamics, the emergence of international production networks and related FDI flows. Recognizing that multilateral disciplines could lead to a narrowing of national policy space for developing countries, regional economic cooperation can provide some means to help countries cope better with globalization. From this perspective, regional institutions could fill gaps in global economic governance structures. The form that such cooperation takes will depend not only on the specific historical, geographical and political circumstances in a region, but also on the relative weight given to market forces and State intervention – a choice that can influence economic policies at the national and global levels.

Over the past two and half decades these policies have been based on the belief that market liberalization and opening up to international trade and finance would lead to the best possible factor allocation in general, and raise productivity and accelerate technological upgrading in developing countries, in particular. This tendency to give priority to market forces in determining factor allocation is reflected in the rapidly increasing number of regional and bilateral free trade agreements (FTAs) or preferential trade agreements (PTAs) concluded since the early 1990s.

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### The “new regionalism”

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The number of trade agreements notified to the GATT/WTO increased from 20 in 1990 to 86 in 2000 and to 159 in 2007. The agreements concluded over the past 20 years have been mainly bilateral, and primarily between developing and developed countries. They have increasingly included provisions aimed at “deep integration”, which involves additional elements for harmonizing national policies in line with a reform agenda that favours greater freedom for market forces – thus also promoting the freedom of movement of TNCs – and reduces options for government intervention. This trend, combined with the increasing number of FTAs and RTAs involving countries from different geographical regions, characterizes what has come to be labelled as “new regionalism”. This term is somewhat misleading, since most of the trade agreements are bilateral and involve countries that are not necessarily in the same geographical region.

“New regionalism” denotes a departure from multilateralism, and has grown out of a sense of frustration of some governments at the slow progress in multilateral trade negotiations. It stems from their belief that a number of bilateral “regional” agreements could serve as a better vehicle for advancing their preferred agenda of economic liberalization and harmonization across a broad range of policies, laws and institutions aimed at promoting the internationalization of investment and production. In a way, this “new regionalism” bypasses multilateral institutions and arrangements, as governments pursue economic objectives and use instruments for which no agreement has been reached at the multilateral level. At the same time, it reflects the tendency to perceive globalization as a process whereby access to markets of the North and attracting FDI from developed-country investors is key to successful integration into the world economy.

The WTO report, *The Future of the WTO*, criticized this proliferation of bilateral and regional trade agreements on the grounds that it has made the most-favoured-nation (MFN) principle the exception rather than the rule, and has led to increased discrimination in world trade. However,

negotiations on FTAs have continued to progress. The United States has been the most energetic in negotiating FTAs, particularly with developing countries. The EU, too, already has bilateral FTAs in various forms with developing countries in all regions, as well as with economies in transition, and it plans to conclude more of them. Japan has been involved in bilateral trade negotiations with several countries in the Asia-Pacific region; and other developed and developing economies, such as the European Free Trade Association, Australia, Chile, China, Mexico, Singapore and Turkey, have also been pursuing a strategy of entering into bilateral PTAs with countries from very diverse regions.

The motivation of a developing country for concluding a bilateral agreement with a developed-country partner is to obtain concessions that are not granted to other countries, particularly better market access for its products. Indeed, bilateral North-South FTAs have the potential to provide the developing-country partner with considerable new trading opportunities, as witnessed by the sharp increase in Mexican manufacturing exports after the conclusion of NAFTA. Such FTAs may also attract more FDI to the developing-country partner. But there can also be potential disadvantages for developing countries, because such FTAs generally demand far-reaching liberalization of foreign investment and government procurement, new rules on certain aspects of competition policy, stricter rules on intellectual property rights, and the incorporation of labour and environmental standards. Moreover, many FTAs oblige developing countries to undertake much broader and deeper liberalization of trade in goods than that agreed under WTO arrangements. Some also involve a form of liberalization of services that differs from what is envisaged in WTO agreements, thus exerting pressure on developing countries to make greater liberalization commitments in this area.

Because they involve reciprocal commitments, FTAs between developed and developing countries eliminate the special and differential treatment that may be granted to developing countries in the context of other agreements. The reciprocity principle in North-South FTAs places developing countries at a disadvantage vis-à-vis their developed-country partners, as they typically enter into the liberalized trade relationship at a less advanced stage of domestic industrial development, implying lower supply and marketing capacities. Moreover, the possibilities of developing countries to benefit from the investment provisions of these FTAs are limited. In order to comply with the principle of reciprocity, developing countries are also forced to cut tariffs from significantly higher levels, especially on industrial products.

Another motivation for joining an FTA is the perceived risk of losing competitiveness vis-à-vis other developing countries that might have entered into an FTA with the same main trading partner. Indeed, unlike negotiations in a multilateral context, individual bilateral negotiations create an environment of competitive liberalization. But the benefits that developing countries can obtain in North-South bilateral negotiations are circumscribed by their usually weaker bargaining power and the limited negotiating flexibility of their developed-country partner. This is due to a combination of strong pressure from domestic lobbies and limitations imposed by existing national legislation, as in the case of the United States, or complex governance and decision-making processes, as in the case of the EU. For example, these factors have made it especially difficult for the major developed countries to accept a reduction or elimination of agricultural subsidies as a negotiable issue in bilateral agreements. Consequently, developing-country partners in bilateral trade agreements are deprived of perhaps the most important potential source of increased market access in the major developed countries. Moreover, a developing country is often unable to derive the full benefits of the improved market access opportunities of an FTA because of limited supply capacities and competitiveness, and because local firms are often unable to comply with restrictive rules of origin on goods destined for export to the developed-country partner. Finally, preferences negotiated by one developing country with a developed partner may quickly be eroded if the same developed country also concludes FTAs with other developing countries.

On the other hand, the developing country has to bear the consequences of eliminating tariffs and other trade barriers in almost all categories of goods. It gives up the possibility to use potentially

important and powerful instruments of industrial and agricultural policy, which are often indispensable for promoting the creation of new production capacities, industrial upgrading and structural change in their economies. All of these are essential for improving the developing country's supply capacity and competitiveness, which are prerequisites for maximizing the potential gains from trade liberalization. Thus the gains for developing countries from improved market access are far from guaranteed, whereas the loss of policy space is certain. It is therefore in the interest of developing countries that the multilateral trade negotiations advance, but with a stronger development dimension built into international trade rules.

Advocates of the "new regionalism" argue that FTAs and PTAs, rather than undermining the multilateral trading system, have the potential to put the multilateral negotiations back on track, precisely because they are part of a strategy of "competitive liberalization". This is because such agreements generally include provisions that extend beyond current WTO rules and regulations in areas such as investment, competition policy and government procurement, as well as in other areas that have been excluded from the agenda of the multilateral trade negotiations. Thus some observers have perceived them as locking in orthodox policy reforms. Yet such reforms have a fairly modest record in terms of enhancing growth and structural change in developing countries, and their underlying principles have come under increasing criticism.

In assessing the potential economic and social benefits and costs of entering into North-South bilateral or regional FTAs, developing countries should not only take into account the potential changes in exports and imports arising from market opening, and possible increases in FDI. They should also consider the impact of such agreements on their ability to use various policy options and instruments in the pursuit of a longer term development strategy. Rather than subscribing to the "new regionalism", which promotes the extension of TNC activities in the developing world, developing countries may examine other areas of cooperation with partners in the same geographical region, in the spirit of true regionalism. This could help strengthen their own strategies for national development and integration into the global economy, building on the advantages of proximity, similarity of interests and economic complementarity.

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## **Regional cooperation and effective integration among developing countries**

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Access to a larger market as a means of achieving scale economies and diversifying production has also been a long-standing rationale for regional arrangements among developing countries. Industrial differentiation broadens the potential for expanding intra-industry trade. Among countries with similar economic structures and technological capabilities, firms that cross various thresholds in terms of size, productivity performance and technological know-how tend increasingly to trade abroad, giving rise to an interactive and cumulative process between internal and external integration. Exports allow scale economies to be further exploited, which can also attract FDI. At the same time a growing outward orientation 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. This is because the initial foreign competition within the region may be less difficult to handle, the technological gap vis-à-vis competitors

from more advanced countries outside the region may be easier to close, and the probability of finding a level playing field is greater.

Formal regional cooperation can be accompanied by very different degrees of effective regional integration, and this has sometimes occurred among countries without the prior conclusion of formal trade arrangements or other far-reaching policy cooperation. Formal agreements on trade liberalization or other forms of regional cooperation are not a precondition for *de facto* integration; in general there is a two-way dynamic interaction between the two. Once external linkages reach a certain level of intensity, there will be pressure from producers to lower or remove the various barriers to intraregional trade, including bureaucratic red tape and conflicting legal restrictions and administrative procedures, as well as demands for better transport and communications infrastructure.

In a world that does not correspond to the perfect competition model of economic theory, and where dynamic interactions between economic and politics shape the path of development, regionally coordinated or common public policies can support regional integration and faster growth. They can do this by bridging gaps left by market mechanisms and by helping to overcome constraints on industrial take-off, diversification and sustained catch-up growth that have a dimension that goes beyond national boundaries, as demonstrated by the experience of post-war Western Europe.

Areas of such active regional cooperation can include apparently simple measures, such as trade and transit facilitation and the dissemination of commercial information. But it is precisely the lack of such measures that are often a major hindrance to closer integration. Regional cooperation in the planning and financing of transport infrastructure to enable physical cross-border trade and reduce its costs is an equally important ingredient for development. Regional management and investment projects in the crucially important areas of energy and water supply, which in many developing countries represent serious bottlenecks, are other instances where regional cooperation can serve development.

Expansion of trade also requires a stable financial and monetary environment. As mentioned earlier, since the international financial system lacks sufficient instruments to reduce the volatility of international financial markets and its impact on developing countries, regional cooperation in monetary and exchange-rate policies has become an important issue. This is a concern not only in Western Europe but also in all developing regions. Indeed, in the absence of far-reaching reform of the international financial architecture, strengthened regional monetary and financial cooperation can be critical for achieving greater coherence between the international financial system and the international trading system while respecting specific developing-country interests.

International, and for that matter regional, trade should not be considered an end in itself; rather it is a means to achieving faster growth. Countries should therefore also investigate innovative areas of policy-making at the regional level that could support diversification and industrialization of their economies. This could, for example, take the form of support for industrial projects and common undertakings in research and development, knowledge generation and information dissemination, that might be too costly and risky for an individual developing country but viable if several countries were to pool their resources.

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## **Adapting regional cooperation to globalization**

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National economies with a successful record of development are characterized by “adaptive efficiency”: the capacity to develop institutions that provide a stable framework for economic activity but which are flexible enough to provide the maximum leeway for policy choices in response to specific challenges. At a time 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. Globalization and the trend towards greater interdependence as a result of internationalization of investment and production decisions present new challenges. Many of these challenges cannot be dealt with exclusively at the national level and may require a similar adaptation of regional institutions, especially as multilateral institutions and policies have failed to adapt.

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. At the same time, new political challenges, including the unequal influence of members, and in particular the ability of stronger members to bypass collective agreements, will have to be dealt with. This implies 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 of regional cooperation suggests that such cooperation is unlikely to follow some established blueprint, that it takes considerable time to evolve, and that the steady build-up of institutional capacity is a critical dimension of success.

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## **Proximity and complementarity can still promote mutual interests**

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Regional arrangements are generally judged against a benchmark derived from standard trade models, which consider fully open borders to goods, services and FDI as prerequisites for successful development. But the underlying assumptions of these models have little to do with economic reality. They fail to consider the possibility of various kinds of market failures and the role that dynamic economic forces and geographical proximity can play in triggering and sustaining virtuous growth circles. In a world with increasing returns, external economies and variable transaction costs, proximity still offers some real economic advantages. Moreover, in the majority of existing regional cooperation agreements, political motivations and influences are an integral part of regional cooperation. From the perspective of conventional trade models, in which market incentives are key to optimal factor allocation, such motivations are inherently suspect. Yet in all healthy market economies, politics and

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economics are in permanent interaction: market failures provide one point of interaction and the provision of public goods another.

There are strong links between internal market integration, intra-industry trade and the formation of regional blocs. Direct investment which usually follows (and is complementary) to these trade flows adds to these links, whereby industries in different countries of the bloc either collaborate in the creation of a single product or specialize in the production of different finished goods for export to the entire bloc or beyond. As a result of these cross-border vertical production relations, trade becomes increasingly intra-firm, intra-industry and intraregional. The key to the formation of these blocs lies with various external economies that derive from the linkage intensity of a more diversified industrial economy, and that maintain the connection between productivity and proximity. This is evidenced by the fact that, despite the process of globalization that has shaped the world economy over the past 25 years, in the larger OECD economies – and even in some of the smaller ones – most firms still produce the largest proportion of their output within national boundaries. Less than a dozen of the biggest TNCs in the Fortune 500 are truly “global” in the sense of having 20 per cent or more of their sales in each of the three large geographical trade blocs – North America, Western Europe and East Asia. Within these blocs, most firms produce most of their output within national boundaries, and, when they do trade or move abroad, most find a disproportionately large number of their markets and locations close to home.

The attitude of developing countries towards regional integration has evolved with their situation in the global economy, their experiences with globalization, and in some cases, with their changing development strategies. Tariff preferences have traditionally been a key instrument for market enlargement and industrial deepening based on the assumption that a larger regional market would increase opportunities for industrial specialization and the realization of scale economies in an otherwise protectionist international environment. Although MFN tariffs have been substantially reduced over the past 20 years as a result of progress in multilateral trade liberalization, preferential access among regional partners may still be a tool for regional trade and industrial integration, even if it is not sufficient by itself to create economic integration, which is associated with increased industrialization and diversification. And regional tariffs could still be an important means of support for sectoral policies, even if the average import tariffs remain relatively low.

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## **Intraregional trade flows**

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Despite the erosion of regional tariff preferences as a result of the reduction in MFN tariffs, various indicators suggest that over the past 20 years intraregional trade in all developing regions has expanded faster than extraregional trade. This is true both for geographical regions and for regional cooperation arrangements. It may have been fostered by the harmonization of standards and the establishment of common rules through policy coordination. Intraregional trade has expanded the most rapidly among the developing countries of East Asia since the mid-1980s, and today represents almost half of that region’s total trade. In Africa, although the share of intraregional trade in its total trade has also increased, it is still less than 10 per cent of its total trade. Intraregional trade in Latin America, excluding Mexico, has grown significantly since the late 1980s, to reach close to 30 per cent of its total trade. The geographical trade pattern of the economies in transition has changed dramatically since the early 1990s, with many Central European countries increasing their trade linkages with

Western Europe, culminating in their accession to EU. Intraregional trade among the economies in transition that are members of the Commonwealth of Independent States (CIS) has been declining, but is still significant, accounting for about a quarter of that group's total trade in 2005. The "geographical bias" in favour of intraregional trade is due to a variety of factors, some of which may be related to formal integration schemes while others benefit from trade-related advantages such as proximity, lower transport costs, tacit knowledge stemming from repeated interaction, and spillovers of various kinds.

Of all developing-country regional arrangements, the Association of Southeast Asian Nations (ASEAN) displays the highest level of intraregional trade in its total trade: 25 per cent on weighted average. Although ASEAN was created as a political rather than an economic grouping, trade among its participants has consistently increased since the mid-1970s. Yet trade liberalization was formalized only in 1992 with the launching of the ASEAN Free Trade Area (AFTA). Developing countries in East and South-East Asia accounted for almost 50 per cent of total ASEAN trade in 2005, compared to only 30 per cent in 1990. This trade expansion has largely been due to the development of a wider regional production network driven by other Asian economies, in particular China, the Republic of Korea and Taiwan Province of China. Its success has encouraged negotiations for enlarging the free trade area to China, the Republic of Korea and Japan.

The pattern of development and integration in East Asia has followed some of the features of European integration, although with distinct characteristics owing to the influences and legacies of colonial rule, the economic gap between Japan and its neighbours and the specific demands of late industrialization. In the integration process, stages of industrialization and regional development have been closely interlinked. The rapid upgrading of economic activity from resource-based and labour-intensive industries to increasingly sophisticated manufactures in the leading economies opened up opportunities for their less developed neighbours to enter the regional division of labour by expanding their less demanding, lower skill, labour-intensive activities that could no longer be competitively supplied by the front runners. In this process, trade and FDI served as vehicles for "redistributing" comparative advantage, and, beginning with post-war Japan, there was a deliberate adoption of pro-investment macroeconomic policies along with strategic industrial and technology policies to serve this objective.

These trends are closely connected with the emergence of regional production networks, either involving large TNCs that produce a standardized set of goods in different locations, or groups of small and medium-sized enterprises located in different countries and linked through international subcontracting to a lead coordinating firm. Both kinds of networks exist in East Asia, although the first kind is more prevalent. China has contributed significantly to the accelerating pace of intraregional trade since the late 1980s, with large firms from the region relocating assembly operations to take advantage of lower costs, and becoming important exporters of intermediate goods to China. Participation in these networks has also been part of the development impetus in South-East Asia, though it is confined to a small number of industries.

In Latin America, formal regional cooperation agreements appear to have played a more important role than in East Asia. Both South American integration agreements, ANCOM and MERCOSUR have been accompanied by a considerable expansion of intraregional trade. But beyond these agreements trade with non-members in the geographical region has also grown faster than trade with the rest of the world, again indicating a geographical bias. However, integration in Latin America was much weaker and less stable than in East Asia with a less dynamic overall economic performance. The reasons for this can be attributed to global shortcomings as well as to inadequate national policies.

This is also partly true for Africa. African countries typically belong to several regional trade arrangements, but in few cases has this led to significant intraregional trade. With the exception of the West African Economic and Monetary Union (UEMOA), which also belongs to the CFA franc zone, and the Southern African Development Community (SADC), intraregional trade has not exceeded

5 per cent of the total trade of the members of these regional agreements. The relatively small weight of intraregional trade in Africa, despite the existence of several (and frequently overlapping) RTAs, is largely due to their production structure and the composition of their exports, as well as the presence of non-tariff barriers and infrastructural constraints. As many countries still specialize in only a small number of primary commodities for export, while most of their imports consist of manufactures, the mismatch between the structures of supply and demand in their international trade limits the potential for intraregional trade. The export-oriented production of their labour-intensive manufactures has not significantly increased their intraregional trade either, because almost all those exports go either to Western Europe or to the United States.

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## The product composition of intraregional trade flows

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The composition of exports has a strong influence on the impact of trade on long-term growth. A comparison between the composition of intraregional and extraregional trade suggests that the former in many cases offers a considerably greater potential for export upgrading than the latter. Regional blocs of developing countries typically represent important, and in many cases dynamic, markets for the manufactured exports of their members, including those of higher skill and technology content. Regional markets generally provide a supportive economic context for local industries in the initial stages of development and are more likely to attract manufacturing FDI than smaller national markets. Thus, increasing trade within the same geographical region can be more conducive to diversification, structural change and industrial upgrading than overall trade. Geographical proximity matters as much as the initial economic structure of each country, but regional trade agreements, as well as other arrangements at the regional level that foster trade integration and greater product diversity, especially in the manufacturing sector, can enhance the positive impact of intraregional trade. Obviously, the geographical directions of external integration – intraregional, with other developing regions, or with developed countries – are not mutually exclusive: a country may benefit from expanding its exports to all these markets. However, for a developing country seeking to upgrade its production structure and the technology content of its domestic industry, an orientation towards the regional market can be an important factor for enhancing the competitiveness of domestic producers and an initial step for integrating into the wider international market.

The growing volume of intraregional trade and, more importantly from a development perspective, an increase in the relative share of manufactures and medium- and high-skilled products, provides a strong argument in favour of a development strategy that links industrialization and regionalism. However, the success of such a strategy requires active cooperation among the members of a regional bloc that goes well beyond liberalizing intraregional trade or the introduction of a common external tariff; it must also ensure a fair distribution of the gains from integration so that each member can reap net benefits from participation.

The reasons for inequalities in the distribution of gains stem from structural factors, but also, in many cases, from economic policies. In a customs union or a common market, the structure of the common external tariff and local content rules are not neutral in the sense that they may serve the interests of some members better than others. Moreover, the members of a regional agreement frequently pursue their own industrial policies – either in accord with their partners or unilaterally. Thus there is the risk that the lack of a coordinated industrial policy could lead to “beggar-thy-neighbour” behaviour,

eventually weakening the integration process. In fact, not all the members of a trading bloc have the same financial and institutional capacities to promote production and exports. The EU dealt with that problem by harmonizing national support policies and by transferring some areas of national policy-making to the regional level so as to enable a better distribution of the gains from integration. In cooperation agreements among developing blocs, this is largely a pending issue, although it is receiving increasing attention.

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## Regional monetary and financial cooperation

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Since the 1990s there has been greater interest in financial and monetary cooperation among developing countries, not least 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 that the vagaries of international financial markets could have on international trade and sustained growth. They showed once again that financial crises are rarely limited to a single country; investor behaviour can easily infect other countries, even if they have good economic fundamentals.

Regional monetary and financial cooperation can take various forms and rely on different instruments. The initial steps may aim at providing long-term financing to participating countries through regional development banks and the creation of regional capital markets. More sophisticated forms of cooperation involve the use of regional clearing banks to facilitate intraregional trade payments and short-term financing for countries facing balance-of-payments problems. Bond issuance in regional currencies and loans in local currencies may help to reduce a currency mismatch and induce the development of regional financial markets.

Further steps towards closer regional cooperation in the field of finance include the creation of regional exchange-rate mechanisms and monetary unions. Regional arrangement for exchange-rate management among countries with a relatively high and increasing share of intraregional trade and financial cooperation can be an important element in the process of creating a common market, as volatility of exchange rates may distort trade flows and undermine trade integration. Even if such arrangements require greater macroeconomic coordination among the participating countries, they can be useful for countries with very open economies targeting stability of the internal and the external value of their currency. Experiences in some regions show that the often severe effects of volatile short-term capital flows, arbitrage and frequent over- and undervaluations, particularly on growth and investment, can be considerably reduced.

Monetary and exchange-rate policy has been by far the most developed area of regional cooperation and integration in Africa. With two currency unions and nominal exchange-rate stabilization in the South African Common Monetary Area (CMA), Africa has taken the lead in the developing world in regional monetary integration. Exchange-rate pegs and the associated greater credibility of their monetary policy have helped a number of countries to achieve convergence in their price levels, though with mixed results due to different exchange-rate regimes. The greatest handicap of exchange-rate based stabilization has been the risk of an appreciation of the real exchange rate due to positive inflation differentials between the domestic and anchor currencies.

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The European experience with different forms of monetary cooperation, which eventually led to a fully-fledged monetary union, offers important lessons for developing countries. It shows that there is no viable alternative to managing some form of fixed or floating exchange rates if adverse implications for trade and the smooth functioning of a common market are to be avoided. Additionally, it implies that regional cooperation in monetary affairs and the design of monetary cooperation in a manner that aims at full monetary union as the final target are superior to systems based on currency anchoring.

However, the failure of European integration to produce an economic performance comparable to that of the United States since the end of the Bretton Woods system shows that for development efforts at the national level to succeed, the formulation and effective implementation of a national development strategy and appropriate macroeconomic policies are of major importance. In this respect, Europe's orthodox approach towards macroeconomic policies holds important lessons for developing countries. The most successful cases of economic catch-up, namely those in Asia, consistently rejected the simple concept of using monetary policy to achieve price stabilization. Indeed, the assignment of policies to reach this target was just the opposite of the orthodox approach. In the Asian model of stabilization, monetary policy sought to stimulate investment and growth whereas heterodox tools were used to control inflation. Income policies or direct government intervention in the goods and labour markets were the preferred instruments to stabilize prices. Clearly, in an environment of extremely rapid growth with its notorious risk of creating an overheated economy, this approach has passed the acid test.

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## **Basic elements of development-oriented regional cooperation**

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Regional cooperation in its simplest form may focus on lowering technical and bureaucratic barriers to trade by means of coordinated administrative reforms and the dissemination of critical information on trading possibilities through trade fairs and the promotion of regional business contacts. Putting in place or upgrading physical infrastructure for transport and communications is a more serious challenge that requires a more advanced form of cooperation and coordinated financial efforts. Cooperation might thereafter progress to the pooling of regional resources in order to meet common challenges, such as accelerating diversification of production in dynamic sectors, upgrading the industrial structure and raising agricultural productivity. Regional cooperation may also be a means of dealing with global public goods, such as knowledge generation and addressing environmental problems.

In some areas, such as trade and transport facilitation, and energy and water supply, regional cooperation is indispensable for most countries in order to identify and overcome bottlenecks that extend beyond national boundaries and for the formulation of proposals that require parallel undertakings in several countries. Improving trade logistics and transport connectivity is an important element of any policy that seeks to improve trade opportunities in order to accelerate growth and structural change. In many cases, formal trade liberalization is not as successful as it might be because some fundamental aspects of trade logistics, such as facilitation of customs formalities, harmonization of procedures and standards are neglected, or are used as non-tariff trade barriers. In other cases, poor infrastructure, or its complete absence, makes trade physically difficult, if not impossible, quite independently of the trade regime. The existence of tariff barriers or quantitative constraints pose formidable obstacles to trade, but they do not render trade exchanges completely impossible, as does the absence of an

appropriate regional infrastructure. Therefore, rather than focusing exclusively on the legal aspects of trade policies in regional cooperation, additional efforts to tackle these other aspects of intraregional economic relations may be as important as, if not more than, further trade liberalization.

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## **Trade logistics are critical**

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Today, high transport costs and poor connectivity are more detrimental to a country's development than ever before; they pose a particular challenge for landlocked developing countries. Many countries, especially in Africa, are still better connected to industrialized countries in other continents through air and maritime transport services than they are to neighbouring countries. Thus their trade is not hindered by distance alone, but also by high transport costs and poor connectivity. These obstacles can be overcome through regional partnerships in trade and transport facilitation, with a view to improving transport infrastructure, transit arrangements and trade facilitation at border crossings.

Trade within a geographical region is often land-based, whereas long-distance trade is mostly seaborne or airborne. For a trade facilitation programme to be coherent with a country's broader trade and development strategy, it is therefore necessary first to decide with which country or region trade should be facilitated as a priority. Enhancing trade with partners outside the region would require an emphasis on measures such as pre-arrival customs clearance at seaports, or the use of port community portal systems or standardized formalities of the International Maritime Organization. If regional integration is the priority, the emphasis would be on measures such as joint border operations, mutual recognition of trade- and transport-related documents and licences within a region, or common documents, and customs automation at border crossings.

Cooperation with neighbouring countries is indispensable, in particular, for landlocked developing countries to become "land-linked". Indeed, such cooperation can serve the mutual interests of landlocked developing countries and coastal transit countries to a much greater extent than is often assumed. It could set in motion a regional dynamic through a virtuous circle of better and less expensive transport infrastructure and market information systems that allows more trade to take place, which in turn may result in economies of scale and greater competition in transport as well as more favourable financial conditions for further improvements of the infrastructure.

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## Benefits of large, energy-related regional infrastructure projects

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Faster growth and expansion of industry in low- and middle-income countries has increased their energy needs. An efficient energy infrastructure is a precondition for economic development in general, and for industrial development and diversification in particular. Yet it is very capital-intensive and often requires large-scale investment, which many developing-country governments find difficult to finance. Mobilizing such financing through privatization may not always be compatible with long-term strategic considerations. Moreover, energy supply and distribution is largely determined by the natural endowments of each country, and only a few countries can meet their energy needs without cooperation with neighbouring countries. The particular structural characteristics of this sector make it prone to market failures, which because of its importance for the functioning and expansion of almost all other sectors, risk being amplified. For all these reasons, regional cooperation in the energy sector can be a starting point for eventual cooperation in other and more far-reaching areas of policy coordination or common policy-making, as shown by the European example. When undertaken among poorer countries, initiatives for regional cooperation in the areas of energy supply and distribution and transport infrastructure, may also serve to leverage external financial support.

Energy and water supply and distribution have been areas of bilateral and regional cooperation in various developing regions, and there appears to be considerable scope for efficiency and security gains from strengthening such cooperation. After disappointing results with a market-based approach in line with wide-ranging policy reforms in the 1980s and 1990s, there has recently been a revival of regional energy cooperation among governments, in particular in Latin America. The perception that both the State and regional cooperation have an important role to play in the energy sector is not new: it was the basis for regional institution-building in post-war Western Europe, even before the creation of the European Economic Community and the European Free Trade Association.

Energy policy in the new millennium should not only ensure that traditional energy supplies match increasing demand; it also needs to focus on innovative measures to increase energy efficiency and support the exploration and use of alternative sources of energy. The challenges in this regard are formidable: the costs of research and technological innovation are high, the adjustment process will be long and uneven, and the potential energy sources are not equally distributed across countries. The importance of these factors grows as industrial development and output growth progress and environmental concerns become more and more acute.

Thus, strengthening forward-looking regional cooperation in the area of energy has the potential to support national policy efforts aimed at accelerating the development of manufacturing industries in developing countries. This new orientation is reflected in the ASEAN 2020 Vision, which recognizes that a greater focus on regional cooperation in energy efficiency and conservation, and on the development of new and renewable energy resources in order to strengthen regional energy security may soon become a determining factor for long-term growth. But translating this intention into concrete action will require supporting policies and financial commitments.

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## Industrial policy as a regional endeavour

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Regional coordination of major investment projects to avoid costly overcapacities in very capital-intensive industries can be an important motivation not only for regional cooperation in the energy sector, but also for industrial policy more generally. Such cooperation is not always easy to achieve because it is often perceived as undermining national interests, especially when it involves financial transfers to a supranational institution. However, the long-term benefits can often outweigh such financial costs, in particular when viewed in terms of its potential, following an initial confidence-building phase, for extending into areas where national capacities are limited. In this regard, the experience of Western Europe, beginning with the European Coal and Steel Community in the early 1950s, contains useful lessons, even though the circumstances differed considerably from those prevailing in today's developing regions.

The growth process is often associated with technological development. Most developing countries rely heavily on accessing technology from abroad for application in local production systems. This requires appropriate national policies and institutions. National innovation systems with an explicit regional dimension could be devised for collaborative research, training schemes and information gathering. These may involve complex institutional issues such as the design of intellectual property regimes, and they may be better supported by the harmonization of rules and laws on a regional basis and by pooling resources to ensure their more effective management in the context of local needs and conditions. Tight budgets and human resource constraints prevent many developing-country governments from offering greater support to "horizontal" industrial policies, for example through more funding for innovation and research and development activities. Often such activities, that generally lack a strong domestic lobby, have relatively long gestation periods and require substantial investments in physical and human capital. Costs of further developing already advanced technologies and adapting them to local conditions can be borne more easily when financed by several governments through a regional cooperation agreement or by regional development banks.

Industrial policy instruments aimed at boosting capital accumulation in manufacturing may vary, depending on whether they are national or regional. While tax incentives are probably more effectively applied at the national level, financing of such investment may well be supported through regional initiatives such as regional development banks or the development of regional financial markets, especially where national financial markets may be too small and the international financial markets inaccessible for various reasons.

Regional cooperation in energy and industrial policy is of course a complement to, not a substitute for, pursuing national strategies, but its scope can extend beyond simple consultation and coordination. It may also involve the financing and implementation of projects that would not be feasible for an individual developing country alone. At the very least, successful cooperation in all these areas is likely to have the indirect effect of confidence-building, thus preparing the ground for more far-reaching forms of regional cooperation.

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## The way forward

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It must be recognized that there are limits to the developmental effects of regional integration arrangements among developing countries, depending on the level of development of the members. Those countries and regions that lack a sizeable capital goods sector have to earn the necessary foreign exchange to enable them to import capital and intermediate goods from the developed or more industrially advanced developing countries. Similarly, those low-income 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 with a more diversified production structure.

Experience over the past 50 years has shown that regional cooperation is neither a necessary nor a sufficient condition for developing strong regional dynamics, but it can help to strengthen national policies and regional integration dynamics resulting from the interaction of private firms. If it is well conceived and responds to the need to overcome region-specific constraints and gaps created by existing global governance structures, there is considerable potential for real benefits from closer regional economic integration. Such integration does not result automatically from trade liberalization. Whatever the potential benefits of trade liberalization at the regional or global levels in terms of accelerating growth and structural change in developing countries, governments may be well advised to explore carefully the policy options available to them in order to maximize the gains from greater trading opportunities both within their region and with other regions. This is particularly important today, as increased integration into the world economy and multilateral commitments are limiting the national policy space and the possibilities for using traditional instruments of trade policy.

Strengthened regional cooperation does not preclude other forms of international or South-South cooperation. While proximity matters for some areas of cooperation, it may be irrelevant for others. An example of the need for South-South cooperation, where proximity does not necessarily matter, is in the coordination of incentives 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 for 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 in offering incentives to potential foreign investors. Regional cooperation in this area would be easier if other elements of cooperation were 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.



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