Regional Integration and Multilateral Cooperation in the Global Economy

Edited by
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Director: Jan Joost Teunissen

Regional Integration and Multilateral Cooperation in the Global Economy

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Abbreviations

ACM	Arab Common Market
ACP	Africa, Caribbean and the Pacific
AEC	African Economic Community
AfDB	African Development Bank
AFTA	ASEAN Free Trade Area
ALADI	Latin American Integration Association
AMU	Arab Maghreb Union
ANZCERTA	Australia New Zealand Closer Economic Relations Trade Agreement
APEC	Asia Pacific Economic Cooperation
APTA	ASEAN Preferential Trading Area
ASEAN	Association of South-East Asian Nations
CAP	Common Agricultural Policy (of the EU)
CBI	Cross-Border Initiative
CEEC	Central and Eastern European country
CEFTA	Central and East European Free Trade Agreement
CEFTA-5	Poland, Czech Republic, Slovakia, Hungary and Slovenia
CFA	Communauté Financière Africaine
CIS	Commonwealth of Independent States
COMESA	Common Market for Eastern and Southern Africa
CUs	customs unions
DBSA	Development Bank of Southern Africa
EAEG	East Asian Economic Group
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECA	Economic Commission for Africa (of the UN)
ECLAC	Economic Commission for Latin America and the Caribbean (of the UN)
ECOWAS	Economic Community of West African States
ECOSOC	Economic and Social Council (of the UN)
ECU	European Currency Unit
EEAC	East Asian Economic Caucus
EMS	European Monetary System
EMU	Economic and Monetary Union
EU	European Union
FDI	foreign direct investment
FTA	free trade area
G-7	Group of Seven
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GCC	Gulf Cooperation Council
GDP	gross domestic product
GDR	German Democratic Republic
GNP	gross national product
GSP	Generalised System of Preferences
IDB	Inter-American Development Bank
IMF	International Monetary Fund
LAIA	Latin American Integration Association (ALADI in Spanish)
LDC	less developed country

LLDC	least-developed country
MENA	Middle East and North Africa
MERCOSUR	Southern Cone Common Market (in Latin America)
MFN	most-favoured nation
NAFTA	North American Free Trade Agreement
MNC	multinational corporation
NATO	North Atlantic Treaty Organization
NTMs	non-tariff measures
OAU	Organisation for African Unity
OECD	Organisation for Economic Cooperation and Development
OPEC	Organization of the Petroleum Exporting Countries
PAFTAD	Pacific Area Free Trade and Development
PAP	People's Action Party (Singapore)
PBEC	Pacific Basin Economic Council
PECC	Pacific Economic Cooperation Council
PPP	purchasing power parity
PTA	preferential trade arrangement
SAARC	South Asian Association for Regional Cooperation
SADC	Southern African Development Community
SAFTA	South Asian Free Trade Area
SAP	structural adjustment programme
SAPTA	South Asian Preferential Trade Area
SDR	special drawing right
SITC	Standard International Trade Classification
SSA	Sub-Saharan Africa
TNF	Trade Negotiating Forum
TRIM	Trade-Related Investment Measure
UEMOA	West African Economic and Monetary Union
UK	United Kingdom
UN	United Nations
US	United States
USSR	Union of Soviet Socialist Republics
VCRs	video-cassette recorders
VERs	voluntary export restraints
WBG	World Bank Group
WIDER	World Institute for Development Economics Research
WTO	World Trade Organization

Introduction

I Fondad's Three-Year Project on Regional Integration and Multilateral Cooperation

When the Forum on Debt and Development (Fondad) started its three-year project on regional economic integration and multilateral cooperation in October 1994, its main objective was to explore how the ideals of regional integration and multilateral cooperation could be promoted, in a mutually reinforcing manner. Specific questions included: What contribution can regional integration of developing and transition countries make to their development? What degree of integration (ranging from free trade to political union) should these countries pursue? What would be the optimal sequencing and speed of integration of the already established (sub-) regions in Latin America, Africa and Asia? What roles could regional markets and institutions play? Is regional integration a stumbling block or a stepping stone to an improvement in the functioning of the global, multilateral finance and trading system? What roles can multilateral and bilateral donors play in fostering both regional integration and multilateral cooperation?

Over the past three years regional seminars were held in Latin America, Africa and Eastern Europe, at which experienced researchers and high-level policymakers jointly addressed these and other questions. In addition, workshops were organised to discuss the issue of how the system of multilateral economic cooperation could be improved from a more global perspective. One such workshop, for example, discussed ways in which future Mexico-style currency crises could be prevented or better managed. The research was further complemented by two studies on the financial policies and practices of the multilateral development banks, and on the issue of how the multilateral debt problem of low-income countries could be resolved. Both studies were authored by Indian economist and investment banker Percy S. Mistry who also wrote the background study of the project. For the publications resulting from the project see the list of Fondad publications at the end of this book.

Fondad's project was concluded by a two-day conference held in November 1997 in The Hague at which papers were presented to highlight the prospects and priorities for integration in Latin America, Africa and Eastern Europe. Similar papers were also prepared on the regions that had not yet been included in the research, i.e. Asia and the Middle East. In addition, papers were prepared on the topic of economic globalisation and on the issue of regionalism versus multilateralism. These papers were presented and discussed at the conference in The Hague in four subsequent panels, whose order corresponds with Parts II to V of this book.

After the conference, we realised that the papers and the ensuing discussions were so rich and encompassing that it would be better to publish them in two separate volumes. This one focuses on the main question raised in the project – how can regional integration contribute optimally to national development as well as to multilateral cooperation? – whereas the other focuses on the policy challenges of the globalising economy (for the contents of the second volume, see the list of Fondad publications at the end of this book).

The latter volume is a kind of 'transition' book serving as a bridge between the Fondad project which has come to a close and the new three-year research project on which it has now embarked. Fondad's new project examines the implications of rapid global financial integration for national and international policymaking. It focuses in particular on the dynamics of private capital flows to non-OECD countries and its consequences for bilateral and multilateral development cooperation.

II The Political and Historical Context of Regional Integration and Multilateral Cooperation

Fondad's project on regionalism and multilateralism – including the conference from which this book results – has focused mainly on the *economic* aspects of regional integration and multilateral cooperation, because we believe that the facilitating economic structures and institutions of regional integration and multilateral cooperation are so crucially important that they deserve special attention. Even more so since the general public is often ill-informed about these matters which are shaping the lives of peoples all over the world. However, I also believe that both regional integration and multilateral cooperation are basically *political* projects. And while supportive economic conditions are needed, the success of both endeavours seems to depend largely on the political support they are able to raise.

Let me illustrate this point by referring to the region which, since the Second World War, has become the success story of regional integration *par excellence:* Europe. If one defines integration rather broadly, one could argue that Europe has had a much longer history of integration dating back to the Greek city-states, the Roman Empire, the Arabic

Mediterranean and Charlemagne's Empire ... and up to the attempts by Napoleon, Bismarck and even Hitler to dominate important parts of Europe. But while these numerous attempts at 'integration' resulted in, at best, the formation of nation-states, it mostly resulted in European disintegration and war. Why? Because of at least one basic flaw: the peoples and countries being 'integrated' were not asked whether they really desired it.

While the 18th, 19th and early 20th centuries were characterised by internal rivalries and attempts at integration, Europe also became the forerunner of what one might call 'global integration', as exemplified by the 'Empire where the sun never set', stretching from Canada to South Africa, India and Australia – to mention just four of the twenty-four countries constituting the British empire at the time.

After WW II, most of these early 'global' integration arrangements pursued by European nations were dissolved, leaving Europe with the sole, but highly desirable, objective of establishing enduring peace and prosperity in its own region. (It is interesting to note that during this time, one of the countries which had already freed itself from Europe's influence, the United States, emerged as the new superpower trying to integrate large parts of the world, economically as well as politically and militarily.)

The further story of European integration is well-known – European statesmen and businessmen feverishly began to construct an ever more united Europe. Having started in the early 1950s as a European Coal and Steel Community with only six member states, they have now reached the stage of an European (Monetary) Union with fifteen member states and ten more candidate countries in Central and Eastern Europe anxiously waiting to join the club.

It goes without saying that this tremendous success in the deepening and widening of the European integration process was substantially facilitated by the regional *economic* structures and institutions that were put in place to foster intra-regional trade and finance. But we must not forget that all of this was only possible thanks to the *political* push for a united Europe. Without such a push, European unity would not have been become reality.

This brief account of European integration points to another issue which I see as one of the major problems of an unbridled process of ever-deepening regional integration: How far should it go? Isn't Europe's energetic embracing of a single currency, the *Euro*, now showing the pitfalls of integration that has gone too fast or too far? Should European nations not put more energy in keeping alive their rich variety of differences – in cultural, social, political and even economic life – rather than almost blindly following the new dogma of 'conversion' of economic policies?

Let me explain. As with other ideals, regional integration should never become a dogma. It is a useful and attractive project as long as those who

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are intended to benefit from it indeed reap the fruits (without jeopardising those who remain outside). But on the day that citizens begin to raise serious and well-founded doubts about the supposed beneficial effects, policymakers and entrepreneurs should begin to rethink the wisdom of ever-increasing regional integration. In my view, regional integration should never become an end in itself, but it should be subdued to the broader and 'higher' goals of justice, social equality, cultural identity and respect for nature. In other words, social, political and cultural (and economic!) considerations can be good reasons for a revision of integration plans.

Returning to the example of European integration, citizens, policymakers and entrepreneurs in Africa, Latin America and Asia should view Europe's interesting experience with regional integration with a critical eye. Only then will they be able to assess the 'real' successes, failures and problems of the European example. And even though the economic aspects of regional integration tend to be the most 'visible' and most widely reported, economic arguments should never blind the public view.

Still one thought about multilateralism. While regionalism may be going too far and too fast, multilateralism is often too restricted and too slow. Again, let me explain. Multilateralism has remained largely an ideal which has achieved only limited success. The United Nations has never become the serious, enthusiastically supported forum for discussion that its founding fathers envisioned. On the contrary, many member states have continuously expressed their reservation about giving too much power (or even any power at all) to the UN. Over the last few years some major members have even refused to pay their full contribution. Only those multilateral organisations which are seen as useful by the major members of the UN – in particular the IMF, World Bank and GATT/WTO – have fared better. But even these organisations have applied the principle of multilateralism with only limited success, as is illustrated by the fact that they are only able to enforce policy prescriptions on the less powerful member states. And though in some cases they have been able to reach agreement by all member states on important new multilateral rules of the game (e.g. GATT's success in completing the Uruguay Round on free trade), many observers – particularly in the developing countries – view their actions as inspired and ruled by the major industrial nations. Officials of the IMF and World Bank keep on repeating, therefore, that poorer countries should get the feeling that they 'own' these institutions. As Mark Malloch Brown, Vice-President of the World Bank, put it at Fondad's concluding conference, "one of our challenges is the question of ownership; we still need to move the World Bank from being a shareholder institution to becoming a stakeholder institution".

With regard to multilateralism, however, there is one area where I remain wary about zealous adherence to the ideal: the current advocacy of a multilateral agreement on investment (MAI). Here, possibly because of the far-reaching success of its predecessor, i.e. the multilateral agreement on free trade, MAI adherents seem too eager on putting their ideal of a world reigned by 'free trade' and 'free investment' into practice. Those who are trying to establish an MAI today should first listen seriously to the criticism that is being voiced in various parts and sectors of the world. A discussion of the pros and cons of the proposed MAI is included in the second volume of the proceedings of Fondad's November 1997 conference.

Let me now introduce some of the extremely interesting economic and political issues that are discussed in this book.

III The Prospects for Integration in the Regions

Europe

The three experts whose papers are included in this volume, each deal with a different aspect of the process of European integration. In a broad and daring view, Hungarian economist András Inotai argues that Europe is facing four major challenges: (i) the *deepening* challenge which results from the internal logic of integration and global competition; (ii) the *enlargement* challenge of incorporating Central and Eastern European countries as full members of the EU; (iii) the *global* challenge of, inter alia, international competition, the problem of unemployment, migration, and illegal and criminal activities; and (iv) the *institutional* challenge of the need for reform of the existing EU integration mechanisms and institutions. Hans Peter Lankes, a German economist working for the European Bank (EBRD), explains why, in his view, the key challenge for Central and Eastern European countries is to enhance government and enterprise capacities. This will not only further transform these countries into well-functioning market economies but also promote their growth and prepare them for EU accession. Piritta Sorsa, a Finnish economist with the IMF, assesses the main challenges of Baltic accession to the EU which include economic stabilisation and structural reform in the Baltics, and the elimination of trade restrictions by the EU.

Both in these papers and the subsequent Floor Discussion a large number of interesting observations are made. On the issue of the *deepening* of EU integration these include for instance: The deeper the integration is, the less countries are able to fully participate in the process; With deeper integration, the mechanisms that have made a major contribution to increased cohesion among EU member countries (e.g. CAP and structural

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funds) will no longer be sustainable; Deepening may divide Europe, and the costs of division and instability will be substantially higher than the costs of a slower pace of deepening.

Also on the issue of EU *enlargement* many interesting observations were made such as: More sub-regional cooperation in Central and Eastern Europe (CEE) is not a precondition but a consequence of successful integration into the EU; EU enlargement will not result in a crowding out of African countries because the trade pattern of CEE is completely different; Trade between the EU and CEE has developed more dynamically in the last five years than any other bilateral trade relationship in Europe; Given the income gap between EU and CEE, enlargement must be based on market integration as well as developmental integration (similar to the development support given previously to Ireland, Greece, Portugal, Spain and the former GDR); The costs for the EU of opening up to CEE and letting in new members from this region tend to be exaggerated; The populations of the candidate countries in CEE should be made aware of the very painful economic reform they will have to go through in order to become a member of the EU.

As regards the *global* and *institutional* challenges, observations included: The success of European integration crucially depends on its competitiveness in global markets, which can be enhanced by making use of the highly educated and flexible labour of Central and Eastern Europe; The EU has to deal with institutional reform before enlargement takes place, and the closer the EU gets to the accession of the first CEE candidate, the greater incentives will be for the present EU members to agree on institutional reform.

Asia and Latin America

The experts who have written the papers on integration in Asia and Latin America present diverging views. Arvind Panagariya from India, who previously worked with the World Bank and co-authored a pioneering study on *New Dimensions in Regional Integration,* argues in his paper that "it is a folly" to push for preferential trade arrangements (PTAs) in general and in Asia in particular. On the other hand, Miria Pigato from Italy, who works with the World Bank, argues that South Asian countries would benefit from promoting a regional trade agreement, particularly in the political and social sphere. Robert Devlin (IDB) from the US and Ricardo Ffrench-Davis (ECLAC) from Chile give a balanced view of the strategic dimensions and rationale of Latin America's regional integration process.

Some of the observations presented in the papers and ensuing Floor Discussion are: Interaction in South Asia has been remarkably low, primarily as a result of non-economic factors; Today's integration in Latin America is driven by powerful political objectives; Most of the regional integration agreements in Latin America, particularly Mercosur, go well beyond preferential trade agreements and receive support of the general public who sees them as a way of bringing countries together; It is often overlooked that in the new context of policy change in Latin America, regional integration is an additional instrument to open the economies to global competition; Latin America has a vested interest in ensuring that regionalism is consistent with a progressively more liberalised and rule-based world trading system, if for no other reason that 80 percent of its trade is extra-regional.

Africa and the Middle East

As Ernest Aryeetey from Ghana observes in his overview paper on the prospects for regional integration in Sub-Saharan Africa (SSA), for many years integration has been regarded by policymakers in Africa as "a highly desirable objective", despite the lack of concrete results. Today, however, says Aryeetey, there is a new perception of how integration should be conceived and pursued. He carefully analyses the main policy recommendations currently circulating in SSA, highlighting those that are likely to influence future courses of action. In a similar way, Mohamed El-Erian, from Egypt, provides insights into the reasons for the limited regional interaction in the Middle East and North Africa (MENA), and identifies the main factors that will influence future interaction. Rosalind Thomas from South Africa critically reviews the recently agreed Trade Protocol of the Southern African Development Community (SADC) and suggests how it should be framed in order to design an agreement that takes the needs of the different member countries into account.

Interesting observations from these papers and the Floor Discussion include: It is becoming increasingly evident that small countries in SSA find it difficult to deal with the many problems they are facing (such as the loss of credibility of national institutions and a lack of resources) and therefore turn to supranational structures and institutions; The growing scope of regional integration is derived partly from the new role of the private sector in various SSA countries; The African Economic Community should develop appropriate macroeconomic frameworks to facilitate greater interaction among the resources of countries, and establish mechanisms for attracting both private and public capital flows from the rest of the world; The harmonisation of macroeconomic policies (particularly monetary and fiscal policies) in SSA is probably more crucial than trade reforms in the creation of trade; The integration of financial markets across coun-

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try borders in SSA is a major way to attract private capital flows; In MENA, favourable developments in the enabling economic environment and the catalyst of the EU Association Agreements will encourage regional interaction; Greater economic interactions are likely to emerge in the form of further integration of the six members of the Gulf Cooperation Council and greater interaction among other sub-groups of Arab economies.

IV The Regionalism vs. Multilateralism Debate Revisited

The fundamental question of whether regionalism can contribute to peace and prosperity in member states of regional groupings as well as to the functioning of a multilateral system which serves the needs of *all* nations, is addressed in Parts I and V of this book.

In his contribution to Part I, Jan Pronk, Minister for Development Cooperation of the Netherlands, who sees himself as "an outspoken proponent of multilateralism", makes a plea for the strengthening of international institutions such as the WTO, the IMF and the World Bank in order to guide the process of economic globalisation. At the same time, however, Pronk argues that "a workable system of international governance does not and cannot exist solely on the basis of global institutions". In his view, regional arrangements are a necessary complement to – and building blocks for – a system of global governance.

Mats Karlsson, Under-Secretary of State for the Swedish Ministry of Foreign Affairs, emphasises the need to strenghten institutions at all levels – local, national, regional and international – in order to cope with the challenges of globalisation. In his view too, regionalism is not opposed to multilateralism, "rather it is a means to secure the benefits for the region of the globalisation process." Like Pronk, he advocates a strengthening of global economic governance. In particular, Karlsson supports the idea of the creation of a World Economic Council "anchored in the United Nations and modelled on an Expanded Security Council of about 23 elected countries".

In Part V of the book, Professor Björn Hettne from Sweden, gives a broad view of the various issues involved in the processes of regionalisation and globalisation, incorporating economic, political, social and cultural aspects in his analysis. Hettne sees the 'new' regionalism largely as a political response to "the market-driven process of globalisation and the social eruptions associated with it". In his view, it is almost self-evident that the *core* regions in the world – East Asia, North America and Europe – are the great supporters of global free trade policies "because the basic point of strong economies is to gain access to weaker economies", whereas the *peripheral* regions are more naturally interested in regionalism as a means to promote development, peace and protection of the environment.

In the last paper of the book, Charles P. Oman (OECD Development Centre), from the US, presents an illuminating view on both the history and the policy challenges of regionalisation and globalisation. Oman stresses that globalisation is not a new phenomenon. "The last 100 years alone have been witness to three distinct periods, or waves, of strong globalisation," he says. In his view, in order to understand the specificity of the globalisation wave of today, "one must grasp the nature of change in the microeconomic forces that drive globalisation". Analysing these microeconomic forces – i.e. the way in which economic activity is organised, both within firms and between firms – he observes that even though globalisation is occurring with respect to markets and management systems, "it really is a misnomer to talk about the globalisation of physical production. ... It is more accurate to talk about the *regionalisation* of production." He concludes that regionalisation – in both its policy-driven and market-driven forms – usually stimulates competition within a region and thus enhances the flexibility of the member countries' economies. In doing so, "globalisation and regionalisation tend naturally to be mutually reinforcing," Oman observes.

Although in the ensuing Floor Discussion of the papers by Hettne and Oman (and in the preceding chapters), different opinions are also voiced, most of the experts included in this book seem to agree that regionalism is, or can be, an important stepping stone to multilateralism. If this conviction is so widespread, how can one explain that the debate about regionalism versus multilateralism is still lingering on. Partly, there are good reasons for it, because regionalism can indeed harm multilateralism. But at the same time, it seems to me that there is a less substantial aspect of the debate which reflects a common phenomenon in social intercourse. When people (and social scientists and politician are by no means an exception) dispute each others' convictions, they tend to reiterate what they believe in, rather than search for facts and insights that contradict their wisdom.

As Richard E. Baldwin from the Graduate Institute of International Studies in Geneva argues in one of his recent writings on regionalism ("The Causes of Regionalism", *The World Economy*, Vol. 20, November 1997): One school-of-thought wishes to view regionalism as having benign effects on multilateralism, and sees the benign effects; another school-of-thought wishes to view it as a threat to multilateralism, and sees the negative effects.

However, this observation does not imply that neither school-of-thought could be put to a test. History provides the facts which – if we agree on their interpretation – indicate whose belief comes closest to real-

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ity. In reviewing the experience with regional integration over the last four decades, Baldwin concludes: "... many fears concerning regionalism are misplaced. ... most regional deals will weaken the key opponents of free trade (import competitors) while simultaneously strengthening its key proponents (exporters). Regional integration will, therefore, foster multilateral liberalisation and vice versa, just as it has done for the past 40 years".

It is in this fact-searching spirit that Fondad started its research project on regionalism and multilateralism in October 1994, and now concludes it with this book and its accompanying volume I referred to above. I hope that these two publications will contribute to better insights in today's globalisation and regionalisation processes as well as to a well-based and broadly endorsed vision of the future.

Jan Joost Teunissen
Director
April 1998

Part I

Globalisation, Regionalisation and Governance

zFrom: *Regional Integration and Multilateral Cooperation in the Global Economy*
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Globalisation and Regionalisation

Jan P. Pronk [1]

I Introduction

The last time I had the pleasure of participating in a Fondad conference, Fondad was following up on its pioneering work on the debt problem of developing countries and the role of the international financial institutions. In the last three years, Fondad's attention has shifted to the issue of regional integration. While the financial and trade aspects of this subject have received substantial attention, Fondad has also included the very important issues of public policymaking and politics in its approach. Regional integration and how it effects global economic cooperation are indeed central themes in today's discussion on the future of global governance. Is regionalisation the answer to the globalisation of markets? Is the second wave of regional integration qualitatively different from earlier attempts? The volume of literature on these subjects is already impressive, but the three-year Fondad research programme that we bring to a conclusion during this conference aims to do more than just add to the existing theory. Fondad's strength has always been in its ability to bring together theory and policy practice, financial experts, development cooperation experts and politicians, from both the North and the South. This mix of expertise contributes to the broader view and lively discussions that distinguish Fondad's meetings.

My contribution to your discussion will concentrate on the two key subjects of the research programme: globalisation and regionalisation. I will first try to draft in broad outline a developmental approach to the globalisation process, and then I will discuss under what circumstances regional integration can make a positive contribution to that approach.

II Globalisation

Although the influence of the globalisation process is, to some extent, counterbalanced by other forces, global trends make clear that we face a number of fundamental worldwide challenges. The globalisation process is

1 Opening Address by Jan P. Pronk, Minister for Development Cooperation of the Netherlands.

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a revolution in the true sense of the word. It is irreversible, and it is profoundly transforming our societies. Technological advances are the driving force behind globalisation and they continue to accelerate our potential in communication and information. Communication and information technology are intensifying economic interdependence on a world scale. This revolution is adding substantial new capacities to human intelligence, and it constitutes a resource that is changing our economies and our ways of life. Thus, the development of technology and its widespread use are preconditions for successful globalisation. Access to it is also a necessary precondition for attaining full membership in the global economy.

In the meantime, it is becoming very clear that economic progress and the maintenance of our natural environment are coming into conflict. We are degrading the world's environment, that is to say we are using up nature as though it was an inexhaustible resource. The present-day methods of production and consumption are clearly not sustainable. Scientific evidence is overwhelmingly convincing that the environment sets limits to human endeavours and that we may, in fact, already be damaging the environment in irreparable ways.

Globalisation confronts us with an additional challenge, and this concerns the world's financial markets. Between 1986 and 1992, global currency transactions increased threefold. As long as enormous profits can be made from the wild swings in exchange values between currencies, the volume of international monetary capital transactions will continue to grow. The resulting volatility and instability of the global financial market are obvious. They are potentially very dangerous. Recent history provides many examples of what may ensue. In 1982, many developing countries, particularly in Latin America, defaulted on their debts. In 1989, Japan's 'bubble economy' of inflated financial values burst. In 1992, the British pound and the Italian lira came under attack. The following year, it was the French franc's turn. In 1995, the Mexican peso collapsed and recently the economies of Southeast Asia unexpectedly became unstable and lost ground.

Of course, the Southeast Asian monetary crisis was caused by local failings. Too much reliance was based on real estate resulting in speculation; the hasty expansion of financial service industries led to uncontrolled excessive bank credits. This revealed the weakness of the financial system. Savings were wasted on unproductive investment, there was an increasing imbalance between the expansion of wealth creating machineries and investment raised for the improvement of the productive potential of society, there was insider profiteering and unscrupulous speculation, monetary policies were undisciplined, fiscal policies inadequate and currencies were overvalued. Obviously, it is necessary for governments and private actors in the region to redress these inadequacies and to clean up their act.

But when all is said and done, I cannot agree with the US Deputy Treasury Secretary when he states that "(the) process of market opening is like peeling an onion … it happens slowly, layer by layer, and there will be plenty of tears involved". That is a recipe for 'cold turkey' treatment as the essential pre-condition to membership in the global economy. For weaker developing nations, this is simply too harsh and socially much too disruptive. It is not the kind of advice that we in the industrialised world would accept for ourselves. The IMF and the WTO are the essential organisations for the regulation of the open, integrated global economy. They must not unwittingly exact a price of social disruption for membership in that community.

These issues, then, are global challenges that need to be guided into acceptable channels. All of humanity should be concerned. Hence, the answers we seek must also be globally coordinated. I emphasise that this does not mean that the worldwide framework is the only one of value. Enhanced regional cooperation is another indispensable international tool that I will come back to. But at the global level, the answers are to be sought in four directions.

First, we must maintain our policies to integrate less strong, developing countries into the world economy. But that transition must be given sufficient time. A big bang entry into the globalisation process without further ado will occasion more victims than the states concerned can permit without regressing into violence. Thus, the process of becoming full member of the economic world community will, for many developing countries, need to be very carefully phased and sequenced. While this manner of managing the enlargement of the global village may be difficult, it is certainly not impossible.

Second, we must strengthen our international institutions. These institutions – notably the WTO, the IMF and the World Bank – are the ones that must guide the transition process I just mentioned. Inter-regional cooperation can certainly assist in smoothing out global differences, but the pre-eminent place of these three international institutions in this respect is equally important. The urgent task is to better equip them so that they can elaborate international rules, guidelines and codes of conduct. Without clear rules and regulations, the globalisation process is not sustainable in the long run. Thus, the strengthening of existing and the establishment of new international organisations is needed as a countervailing power to transnational corporations and the financial sector.

The third area which requires answers to the challenges posed by globalisation concerns the non-economic dimensions of the global market. In its present form, globalisation is an economically and technologically driven process that disregards political considerations. To put it somewhat

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bluntly, it is a 'mindless' process that will accelerate inequality, ecological disaster, poverty and identity conflicts in many parts of the world. An increasingly commercially financed world, which only extends materialistic western lifestyles without regard to the non-economic bonds that form the essence of societies, will end up in dissent, strife and resistance. It will cause debilitating backlashes against the very progress people need and want. It is also an extremely dangerous illusion to think that these disasters will only happen elsewhere. A globalised world means precisely that.

Fourth and finally, we must do more to promote democracy, human rights and cultural pluriformity. The liberty and intrinsic worth of the individual are the very basis of western culture. These values must be cherished and strengthened. They are the heart of what makes our societies work. They must also be at the heart of our relationship with non-western societies. Without them, policies to promote and protect long-term, peaceful global relationships are doomed to fail. A global world must have a global, inter-cultural dialogue. Such a dialogue can only be useful if it is based on a shared, deep mutual respect. This means that we give others the benefit of the doubt. We live in multicultural societies or in ones that are rapidly acquiring a multicultural character. Inter-cultural collisions are frequent everywhere. To solve these problems, we need to make globalisation more than just an economic and technological process.

III Regionalisation

While I have just stated that international governance must be strengthened in order to cope with a globalised economy, I should also add that a workable system of international governance does not and cannot exist solely on the basis of global institutions. Some issues are best dealt with regionally. Even an outspoken proponent of multilateralism like myself agrees with this statement. Within an overall global framework of rules and order, the principle of subsidiarity or optimal decentralisation can be usefully applied. As has also been noted in the report of the Carlsson Commission[2], it is not difficult to realise that there are limits to the capacity of multilateral institutions to regulate and coordinate effectively at a global level. In my view, regional arrangements can be seen as a necessary complement to – and even as building blocks for – a system of global

2 In 1991, the Carlsson Commission, also referred to as the 'second Brandt Commission', published a memorandum entitled *Common Responsibility: An Initiative on Global Security and Governance for the 1990s.* The memorandum, which developed the work of the Brandt, Palme and Brundtland Commissions was jointly prepared by former Swedish Prime Minister Ingvar Carlsson, former Commonwealth Secretary General Shridath Ramphal and Jan P. Pronk.

governance. The differences between regions are real. Their different paths towards development and integration in the world economy can best be accommodated by using the stepping stone of regional integration.

Regionalisation is, first of all, a concrete reality. It is sometimes said that globalisation is market-led and regionalisation is policy-led, but in many ways regionalisation is driven by the same market forces and technological developments as globalisation. Intra-regional trade is growing faster than trade between regions. Relocation of production is primarily a regional phenomenon. As Charles Oman has shown in his paper, physical proximity between firms and both their customers and suppliers has become more, not less, important. Regional integration can thus be seen as the logical follow up to these market developments. But regional integration has a broader motivation than free trade and investment.

Much of the inspiration of present day regionalism is indeed political. I might describe it, in part, as a political reaction to the globalisation of markets, stemming from the desire to retain a certain amount of policy autonomy of governments vis-à-vis market forces. The strong growth, some say proliferation, in the number of regional arrangements is part of the new post-Cold War context. In that multipolar world, regional initiatives are often stimulated by regional agreements elsewhere. In this respect, the European Union has set off integration efforts in many other parts of the world.

As I said, regionalism as a form of international governance is related to the changing position of the state. It is no longer possible to regulate purely on the basis of national jurisdiction. The alternative of multilateral rule-making is not only difficult to achieve, but it is often too remote from national interest groups to be acceptable. Regional integration can offer a middle way that preserves the notion that citizens and their nations are still in control of events. This makes deeper integration possible in certain regions. Deeper in the sense that the concept is broadened to cover competition policy, investment, and even the free movement of persons. Integration in world markets through regionalism can thus be phased according to the differing economic circumstances of the countries concerned.

There are many other political motives for regional integration. Increasing the bargaining power of smaller states in multilateral economic negotiations is an example. But non-economic policy goals are often just as important, if not more so. Regional security plays a role, as has been the case in Europe. I fully sympathise with the WIDER approach towards regionalism as outlined in the paper of Björn Hettne, who stresses the political basis of regional integration. He rightly mentions security and development as the key elements of regionalism in Third World regions

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today. Such a broadening of the concept of regionalism adds to the complexity of the phenomenon. There are many forms of regionalism and any assessment will have to take into account the different goals and positions of various regional groupings.

IV A Developmental Approach

In my analysis of regionalism I have stressed its multidimensional and differentiated character, its political motivation and the complementary role it can play in strengthening international governance. How does this analysis relate to the central theme of this Fondad conference, i.e. the relation between regionalism and global economic cooperation? Three key questions emerge as possible focal points for your discussion in the coming days: (1) the definition of the concept of openness; (2) the specific character of regionalism in different parts of the world; and (3) the way in which cooperation between regions can best be organised.

What sort of regionalism will be most conducive to the emergence of a strong multilateral system? The ideal model is often called 'open regionalism', but this term is ill-defined and contains an uneasy sort of paradox. At best, the openness of an arrangement can be described in general terms as a non-static, flexible and differentiated process, transparent and open to new members. Defensive, inward-looking regionalism can indeed interfere with the principles of the multilateral trade system. There is a risk of an escalation of defensive regional agreements, leading to a fragmentation of the world trade system. The costs of such a development would fall disproportionately on weaker countries outside the major blocs. WTO rules provide some criteria for an assessment of the character of regional agreements, but these criteria are not as yet very operational. In any case, traditional economic analysis of trade creation and trade diversion is too narrow in scope for a multidimensional phenomenon like regional integration. I believe we need a broader framework for assessment which includes non-economic elements.

Differentiation might be the second point for discussion. The optimal degree of regionalism will be different for the various regions. Each region is confronted with its own challenges. The European Union has accomplished deep integration in a number of fields, but is now facing difficult choices regarding further (especially monetary) integration, enlargement and liberalisation of agricultural policies. East Asia and Southeast Asia are examples of a market-led, open type of regional cooperation. The recent financial crisis in that part of Asia might provide a boost for new formal regional mechanisms. In the Western Hemisphere, the initial drive of the

United States towards regional arrangements seems to be waning. In Africa, regionalism is still in its infancy. Security and investment cooperation are obvious priorities for cooperation in that region.

Differences exist within regions as well. A region like East Asia is far from homogeneous. What determines the borders between regions and how can this be related to their development strategies? I hope that the discussion on the particular situation in the various regions, based on the outcome of the regional Fondad conferences, will shed some light on these difficult questions during the following days.

My third point concerns the interaction between regions and its relation to the multilateral system. The number of inter-regional cooperation fora has grown rapidly in the last few years. APEC, the Transatlantic Agenda and EU-ASEAN are among the most important. These fora can contribute to international governance but only if they do not develop into alternatives to the multilateral system. The dominance of the three major regions can undermine the position of developing countries falling outside these regions. As co-founders of the multilateral system, Europe and the US have a special responsibility for preserving the spirit of multilateralism. Strengthening the multilateral system should therefore be a key objective of the new transatlantic agenda.

An outward-looking European Union will have to take the initiative to prevent the exclusion of developing countries, especially those in Africa. At this moment, the EU is already confronted with this challenge in two concrete cases. The first is the renewal of the Lomé Treaty. The group of ACP countries is comprised of three different regions which run the risk of becoming marginalised. The second case is the commencement of the EMU. What is the significance of further monetary integration in Europe for countries outside EMU, in particular developing countries and countries in transition? Can monetary cooperation with the franc zone in Western Africa be extended to the EMU or is this form of cooperation no longer viable? I realise that this is more than a technical question, but it would be interesting to hear the opinion of the experts gathered here today.

Chairman, I want to reiterate my main points. Globalisation as a technology-driven, irreversible development; the threats to our very survival emanating from man-made changes to our natural environment; and the instability of world-wide capital transactions all call for stronger international governance. I have outlined the main elements of a developmental approach to these challenges. Regionalisation, as a political reaction to the globalisation of markets, can play an important role in the strengthening of international governance. The question is what kind of regionalisation and inter-regional cooperation will contribute most to the strengthening of

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international governance. We need a broad framework for assessing the openness of regional agreements, and the optimal degree of openness will probably be different for each region. I believe that Europe, as a model for regional integration and supporter of the multilateral system, will play a crucial role in this development. I trust that Fondad will provide us with some valuable guidance in finding a productive relationship between regional integration and global cooperation.

Globalisation, Regionalism and Global Economic Governance

Mats Karlsson[1]

I Globalisation

Rapid growth in trade and international capital flows, continuous technological progress and an exponential increase in the exchange of information are transforming the global scene as the industrial revolution once did. Globalisation is the now popularised concept for the intensified interdependence that has been a phenomenon for decades, but which is currently accelerating with unprecedented momentum. Globalisation can provide the opportunity for millions of individuals to step out of extreme poverty.

The advantages of an open trade system are no longer disputed. But it is perhaps the most controversial form of globalisation – private portfolio flows – which offers an avenue of hope to the poor. It has created mechanisms for a massive transfer of resources from rich countries to low-income countries, via mutual funds, pension funds, etc. The problem is that this potential is seldom transformed into sustained improvements. On the contrary, globalisation has created new patterns of exclusion and inequality. Marginalisation, insecurity and powerlessness is the real consequence of globalisation for many. Why is this so? The explanation has to do with the widening gap between the challenges of the global market forces, including exponential technological advances on the one hand, and the capacity of the political and social institutions at local, national and international levels on the other. In short, we do not have the institutions to cope with this new and far-reaching form of interdependence.

Globalisation means a challenge to political and social institutions at all levels. At the local level, traditional structures are disrupted or even, at times, eroded. The autonomy of national governments is curtailed. And appropriate structures and institutions are lacking at the international level. There are no simple solutions. The local and national levels must continue to play the important roles they have always played. The creation of a 'global society' or 'global nation' is neither possible nor desirable. In

1 Closing Address given by Mats Karlsson, Under-Secretary of State, Swedish Ministry of Foreign Affairs.

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order to realise its potential, globalisation must not weaken but strengthen social inclusion and cohesion at all levels. This also holds true for the regional level as I will come back to later.

We can consider the example of national economic growth, the most common development indicator. Let us assume that globalisation leads to higher growth – at least in a short to medium term perspective. But since growth figures are national averages, they reveal very little about the quality of life of different groups of people in the country. They also tell us very little about the factors that are crucial for long-term sustainable growth, like the development of social capital. Fortunately, we realise now that it is not just growth that is important, but it is a special type or pattern of growth. This growth should be pro-poor, pro-women and sustainable in economic, political, social and environmental terms. The IMF calls this *high-quality growth*. What is necessary to insure that globalisation leads to high-quality growth? Basically, strong institutions at all levels. They must be strong, not to regulate or intervene in markets, but strong to guarantee that markets are not captured by elites. Strong institutions do not have to be big. It is, however, crucial that they are legitimate and open.

Many studies have concluded that the most important factor behind rapid economic growth has been a good economic policy. We should, however, add a few dimensions to the concept of 'good policies'. The macroeconomic fundamentals are important, but they are not sufficient for achieving 'high-quality growth'. Good governance, equity and environmental sustainability are other fundamental components.

II Regionalism

One has to make a clear distinction between the old and the new regionalism. The old regionalism was based on the idea of import substitution and of creating a larger 'national' market. In this way, it was opposed to globalisation. Traditional theories of economic integration suggested that it could lead to trade creation, but in most low-income regions trade structures are very similar and the potential for trade creation is limited. This is one reason behind the unsuccessful experiences of regional economic integration among low-income countries.

Globalisation means a challenge to regional integration. Björn Hettne describes the 'new regionalism' as a way of meeting this challenge. The new regionalism is not opposed to globalisation, rather it is a means to secure the benefits for the region of the globalisation process. In economic terms, the new regionalism does not aim primarily at trade creation but rather at increasing credibility and attracting sustainable private capital flows. But more is needed in order to realise the potential of globalisation and transform it into high-quality growth for a region. Social cohesion must be maintained at the local and national level while it is complemented by a kind of regional culture or 'regionness'. This is a complicated process as we know from the European experience.

The new regionalism is not opposed to globalisation or the opening up of national economies, but how does it relate to *multilateralism*? There is a possibility for a conflict between regionalism and multilateralism as regionalism grows stronger – also involving North-South relations. Such a conflict is not a desirable scenario, and the best way to reduce the probability for it to come true is to strengthen the basic multilateral framework. The structure for multilateral trade negotiations must be kept and developed and the trend towards global free trade must be secured. The UN system must be guaranteed adequate and predictable financing and the international financial institutions must keep, and in some areas broaden, their mandate and receive adequate funding for this. But they must also continue their process of becoming more open and accountable, and adapt their methods to a world with strong regional institutions. To avoid misunderstandings, let me just say that this could, and will most probably, be achieved in parallel with increased regionalism.

III Global Economic Governance

The recent Southeast Asian crisis does not illustrate the problem of globalisation and capital flows, but rather the problem of weak institutions and imperfect information. The market is sometimes irrational and ignorant; it bases its decisions on irrelevant factors and treats countries with very different situations similarly only because they are close to each other geographically. This creates high risks for both depositors in rich countries and for the low-income countries receiving capital inflows. Stephany Griffith-Jones put forward a number of proposals which are interesting as a starting point discussing how we should deal with this problem.[2]

But the crisis also illustrates the challenge facing the global institutions. The IMF was successful in delivering rescue packages for Thailand and Indonesia, but questions have been raised about how long these emergency operations can continue and what incentives they create. A more crucial need is an early warning system which can signal when measures must be

2 See "Regulatory Challenges for Source Countries of Surges in Capital Flows", In: J.J. Teunissen (ed.), *The Policy Challenges of Global Financial Integration*, FONDAD, The Hague.

taken, by governments as well as by international creditors and investors, to correct the situation at an early stage.

What we are touching upon here is the area of *global economic governance*. We have an array of institutions including the well-known global institutions, the regional organisations, arrangements under binding treaties such as the Montreal Protocol or informal practices such as the Paris Club, and there is evolving interaction with the private sector in setting standards. Together, they reveal the state of global economic governance. But more than one nation has been known to say one thing here, another there, and do a third thing in practice – perhaps all in good faith and for good reasons. Regrettable, the result in terms of global efficiency will not be achieved by design. Each one of the international institutions will maintain its own *raison d'être*, decisionmaking processes and operational practices. But until we instil some coherence, nations stand no chance of closing the gap between the challenges of the global marketplace and the institutions they require.

With regard to leadership, the G-7 certainly considers itself to have a leadership role, but its interests and representativeness and, therefore, legitimacy in relation to many other economic actors, including the emerging major economies, are limited. The ECOSOC and other UN economic bodies simply do not yet have the clout. Other global organisations may have strong institutional leadership, but their mandate is limited. The European Union has hardly begun dealing with its own coherence problems. The OECD, for all its good work, is facing serious choices about what kind of organisation it will become in the future.

Take the following examples where coherent leadership is needed:
- institutional responsibility in global financial markets;
- the historic scandal that 15 years after the onset of the debt crisis, there is still no exit for many of the poorest nations;
- support in transition countries dealing with post-communist legacies or the many complex crises and humanitarian disasters;
- the confusion about roles and responsibilities in trade, development and aid;
- we have hardly begun negotiating the global issues at stake with regard to the environment, energy and water – none can have one institutional home.

We need mechanisms that can result in coherent, institution-spanning approaches by governments for these and many other policy issues and concrete situations. A new bureaucratic structure is not needed. Instead, we need a political apex forum on economic, social and environmental matters.

The idea that I support is the creation of an Economic Security Council or a World Economic Council anchored in the United Nations and modelled on an expanded Security Council of about 23 elected countries. It would hold a periodic meeting of top national leaders and the heads of the major global economic institutions. The Economic Security Council's aim would be to exercise leadership, instil coherence and initiate action which, for the most part, would be decided upon and carried out by existing organisations. Variants of this idea are possible.

Few institutions are created simply from the drawing-board. A pragmatic way to start would be to convene a small summit of heads of state to address the issues of globalisation. However, I have no doubt that something of the kind – a high-level forum for leadership and coherence in global economic governance – will be created. The reality of interdependence in a world where the weight of the emerging markets is rapidly increasing makes it a necessity. This will be the real test case of whether we can handle globalisation politically.

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Part II

Europe

Prospects and Priorities of Regional Integration in Europe with Special Regard to Eastern Enlargement

András Inotai

I Introduction

Europe's 20th century history is characterised by a constant process of integration and disintegration. Though substantial differences in the level of economic development persisted, the continent was economically united before the end of the first world war. As a consequence of the peace treaties of 1919 and, later, as a result of the Great Depression, Europe became fragmented, autarchic and nationalist. Between the First and Second World War, the centre of growth and technological development shifted to the other side of the Atlantic, and the United States emerged as the clear economic leader of the world. Interestingly, while the European continent disintegrated, rapid growth and modernisation in Scandinavia – an economically backward and peripheral region before 1918 – created favourable conditions for increased European integration.

The outcome of the Second World War gave substantial support to both integration and disintegration. Europe became a split continent with strong integration tendencies, although patterned differently, in both the eastern and western parts of the continent. As a result of many factors including security aspects, domestic economic development and especially the implementation of the 'developmental pattern' of Western European integration, the peripheral Southern European countries and, even earlier Ireland, could be included in the Western European architecture.

Finally, the fall of the Berlin Wall had a fundamental impact on more recent integration processes in Europe. On the one hand, it ended the division of Europe and eliminated the ideological and political barriers to the integration of the whole continent. On the other hand, the fragmented character of Europe became more manifest and was substantially exacerbated by institutional disintegration as several states, created in different periods of European history, fell apart within a few years.

Europe now has a historical opportunity to foster the elements of integration and continue with the almost half-century long process of integration on a qualitatively new, continental level. Within one century, and fol-

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lowing Scandinavia and the Mediterranean, a third periphery, Central and Eastern Europe, is expected to become an integral part of 'modern Europe' in the next decade(s). In other words, the more developed part of Europe is once again being challenged by the next 'geographic sequencing' of expanding the boundaries of an integrated Europe towards the East. There is no doubt about the difficulties, uncertainties and likely traps of such an undertaking. First, the main actor of the process, the European Union, is simultaneously facing a number of other challenges. Second, the 'geographic sequencing' in itself raises questions, dilemmas, expectations and fears which must be properly addressed.

In this paper, I approach some basic issues, primarily concerning the eastern enlargement of the European Union, from an optimistic viewpoint. I am completely aware that there are other, less promising – and not unlikely – scenarios as well. It is the size of the paper and the hopefully not unjustified optimism of the author which explain why other possible scenarios have not been elaborated.

II Regional Integration in Europe

Unlike regionalism in some other continents, regionalism in Europe is characterised by several unique features. First, there is a clear gravitation centre of integration, the European Union (EU), and there are various sub-regional groups rotating around this centre; frequently from an external periphery position, but sometimes also from within the EU itself (regionalism within the EU). Second, Western European integration has reached a much higher level than any regional integration effort in other parts of the world. Partly, this is based on very strong micro-level integration of trade, services, finance and corporate governance. And partly, and not less importantly, the integration is highly institutionalised with Brussels being responsible for many issues that are an unquestionable part of national sovereignty in other parts of the world. Third, during the past decades the European Union has elaborated and implemented a two-tier integration pattern, consisting of market integration and developmental integration. This enabled less developed (member) countries to become increasingly integrated into the structure created by the more developed 'core' countries of Europe.

A second set of differences stems from a comparison of the present features to earlier characteristics of the European integration process. The European Union has never been so challenged by external developments as in the last years of this century. Some of the global challenges are institutionalised (WTO and other international organisations), some come from everyday business practice (competition), and some contain elements of uncertainty and even fear (migration, illegal and criminal activities). One has to emphasise that all of these challenges have a much wider scope than the consequences of Central and Eastern European developments, even though the post-1989 European situation may have contributed to higher 'sensitivity' in Western Europe for these challenges.

Beside the changing global role of the European Union, the integration process in Europe has also reached a qualitatively new level. To some extent, it became victim of its earlier successes. First, because more and more countries now consider the EU their modernisation anchor and would, therefore, like to become members of the Union as soon as possible. Second, because the internal logic of integration (and global competition) forces the member states to extend the scope of integration to new areas which were previously viewed as symbols of national identity (e.g. monetary policy).

The necessary deepening creates integrative and disintegrative trends at the same time. The deeper the integration is, the less countries are able to fully participate in the process. As a result, deeper integration produces fragmentation, albeit perhaps temporarily, *within* the previously integrated structure. Another threat of deeper integration is the non-sustainability of some integration mechanisms that have substantially contributed to the strengthening of cohesion among member countries in the past (common agricultural policy and structural funds but also institutional issues). In addition, most member countries are just now facing serious domestic problems (the future of welfare state, social and institutional flexibility, etc.) which may cause conflict between national priorities and commitment to integration. Finally, new and rather dynamic developments in Europe, including the pressure for early membership by the candidate Central and Eastern European countries, affect the European Union. To be sure, for decades, the European integration process has been developing in spite of crises, but the present situation is completely different. In quantitative terms, there are several overlapping crises which bring the given architecture into question. In qualitative terms, the current critical issues have to be settled in the global framework and, more importantly, without having an external enemy as a 'threatening anchor'.

It is no wonder that most of these problems have exploded the previously rather well-locked framework of Western European policymaking. All previous negotiations on enlargement were a matter of politicians and a few interest groups to be affected by accession of a given country. In the core countries of the EU, the accession of any country was considered as a security and political issue, settled in the traditional diplomatic way. The likely impacts, both positive and negative, did not filter down to the society. This time, however, we are witnessing an almost uncontrolled internalisation of all justified or unjustified concerns about eastern enlargement in practically all EU member countries. In fact, most of the fears result from increasing global competition, the accumulation of domestic problems that have been hidden by the status quo of a divided Europe, and the new challenges of European integration instead of from any 'Eastern threat'. Unfortunately, this distinction has not been properly communicated until now in the societies of EU member countries.

III The Challenge from Central and Eastern Europe

Since 1989, the process of integration has been accompanied by different processes of disintegration in the continent. While the EU became the unquestionable leader of European integration, its impact on selected countries of the continent varied (pyramid of preferences, including different levels of EU maturity and the EU's willingness to take new members). As a consequence, two parallel and contradictory processes evolved. On the one hand, the integration process became stronger by involving ten Central and Eastern European transforming countries into the institutional, political, trade and economic network of Brussels. On the other hand, the countries involved could make use of the new frameworks in different manners, as indicated by the share and structure of trade with the EU, subcontracting, intra-industry division of labour and cross-border programmes. Also, their transformation process in regional comparison shows substantial differences leading to the feeling of growing marginalisation in some countries despite the fact that they had signed the same Association Agreements as some more advanced countries. Moreover, not all countries of Central and Eastern Europe were grouped under this umbrella. As a result, though the previously institutionalised ideological, political, economic and income gap between Western and Eastern Europe was eliminated by the collapse of the Soviet empire, new gaps based on differences in income and development levels started emerging. Today, there are at least three (or four) serious income gaps within Europe – between Western, Central, Southeastern Europe and the successor states of the USSR. The income difference between Central and Western Europe is no larger than the income gap between Central and Southeastern Europe. In addition, a more differentiated situation is also unfolding within the present map of the EU. Eastern enlargement is likely to strengthen these differences. So the challenge of European integration is to cope with fundamentally different income and development levels.

In *Agenda 2000*, the Commission has tried to answer this question by

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providing an encompassing and flexible strategy for eastern enlargement and proposing the initiation of negotiations with the more advanced applicant countries early 1998. The differentiation of applicants made by the Commission was a bold political step, although it was by far no scientific discovery. It simply acknowledged realities in Europe and attempted to deal with them adequately. It must be emphasised that differences do not emerge because someone is talking about them. On the contrary, existing differences can only be kept under control as long as policymakers are completely aware of them and of the consequences stemming from such a varied situation.

A differentiated approach should not lead to disappointment in countries not included in the proposed first round of negotiations with Brussels. If properly handled, factors of instability can be effectively controlled (except for instabilities deriving from other sources for which the EU must not be made responsible).[1] In this context, the overall enlargement strategy must be filled with substance. Instruments which have already been proposed by the Commission could be complemented by large infrastructure projects running through the first-round candidate countries into other candidate countries. Such projects would have an important economic impact as well as an equally important psychological one, i.e. suggesting that all candidate countries are ultimately expected to become member of the Union.

Coping with growing differences across Europe goes beyond the discussion about the forms of eastern enlargement. In fact, there is a potential conflict in the development pattern of the EU itself. Before, or shortly after, the fall of the Berlin Wall, the key elements of the longer-term development of the EU were defined on the basis of the old concept of 'keep Germany in and down'. For many policymakers, deepening became the 'second-worst' scenario (when compared to widening and its consequences). In the last few years, increasing global challenges have also fostered attempts at deepening. However justified this attempt may be, two dangers have not been considered. First, deepening may collide with national interests within the EU and the uncertain social flexibility of Western European societies.[2] Second, deepening may divide Europe, and the costs of division (and instability) may be substantially higher than the

1 A higher level of instability could indeed be expected from the *non*-differentiation which would transmit a very bad message to the more advanced Central European countries. If disillusioned, these countries may transfer instability problems to the very borders of the European Union, which would hardly be a welcome development for Brussels, Germany, Austria or Italy.

2 It is more than interesting that the social and economic consequences of EMU have not been analysed in detail, while most experts and policymakers seem to be fully committed to this project.

costs of a slower pace of deepening. While the Commission thinks it has 'solved' this dilemma by their simultaneous support of deepening and widening, the real solution must come from European developments in the coming few years. Integration in Europe cannot be separated into different clusters. The genuine integration of Central (and Eastern) Europe into a stable European pattern needs both a security and an economic modernisation anchor. Evidently, modernisation cannot be successful without guaranteed security in the continent, at least in the crucial years of modernisation. In turn, stability cannot be sustained without successful modernisation and a quick catching-up process, the fruits of which will be perceived by large parts of Central and Eastern European societies.

Considering the essential income gap (measured in GDP per capita terms) in the continent, regional integration must be based on two patterns: market integration and developmental integration. The last element has been widely used in the integration process of Ireland, Greece, Portugal, Spain, and most recently, former GDR. All of the current candidate countries will require instruments of developmental integration since they are much less developed than the EU average. However, the same pattern should also be used by Central Europe with regard to Eastern Europe (with the entry of Romania into CEFTA, sub-regional income differences are likely to become more exacerbated than in CEFTA-5).

Although they are substantial at the moment, income gaps can more easily be narrowed than forecasts based on different growth rates point out. In fact, the experience of Ireland and the Mediterranean member countries indicates that the catching-up process can be explained by the appreciation of the national currency to 75-90% while the impact of growth differential is only 20-25%.

More concern is justified regarding the future of financial transfers. In the past, Germany has financed the expansion of EU transfers. But Germany seems unable to continue with this practice even though the current beneficiaries are not ready to sacrifice part of their benefits to the newcomers. The sometimes – not fully understandable – race to the EMU and the forceful – and probably unsustainable – fulfilment of the Maastricht budget deficit criteria may limit the readiness of the present member countries to a redistribution of resources in favour of the new entrants. In addition, the German behaviour, motivated by 'enlightened self-interest', can hardly be expected from any other country (least of all by France, although Germany very much supported the Mediterranean enlargement).

Taking into account that the EU is the indisputable core of the European integration process, each country looks at fostering its relations with the EU. Sub-regional cooperation and integration is generally not viewed as a second-best option, but as an imposed waiting room before membership in the EU. According to general experience (not only from Europe), more sub-regional cooperation is not a precondition but a consequence of successful integration into the developed European structures. Spain and Portugal started meaningful economic cooperation after (and not before, let alone instead of) membership in the EU. Similarly, trade among first-round Central European countries is expected to rise from about 8% in 1996 to about 12% in the first years *after* membership.

IV Global Environment and European Integration

The success of European integration crucially depends on its competitiveness in global markets. The sustainability or increase of Europe's global position has several preconditions including:

- guaranteed and predictable security (in order to concentrate resources on economic development instead of emergency measures to keep repeated crises under control);
- making use of the advantages offered by economies-of-scale production, based on the larger European market, with particular emphasis on products in high demand by Central and Eastern Europe (environment, investment machinery, selected consumer goods, etc.);
- development of new technologies by benefiting either from economies-of-scale production or from the technological knowledge available in Central and Eastern Europe;
- reduction of the economic and social costs of production by mainly using competitive production units in Central and Eastern Europe;
- higher flexibility of the labour market since capital is already moving freely around the world and is looking for the best investment locations in global comparison. Inflexible labour markets will necessarily increase capital outflows which, in the longer term, may result in general capital shortage, undercapitalisation and underdevelopment in the currently most developed part of Europe;
- finally, and probably most importantly, higher social and institutional flexibility is a major precondition for global competitiveness in the next century.

Eastern enlargement is not only important considering the aspects already mentioned in the previous paragraphs. In contrast to earlier enlargements, this will be the first one which is really taking place in a globalising economy. Therefore, eastern enlargement is not an intra-European affair. It is a major factor of Europe's future competitiveness. Costs and benefits of enlargement have to be assessed accordingly.

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V Europe's Present Position in International Comparison

Despite the undeniable gap in economic development level, income, social welfare, institutional setup and mentality, most European countries share some common features.

First, Europe has been struggling with low growth rates for a number of years now, and this situation is unlikely to change. In contrast, the transforming countries may achieve higher and sustainable growth rates in the coming years. While there is a lot of uncertainty about longer term growth, those Central and Eastern European countries which have reached the second stage of transformation (transformation with modernisation) are likely to have sustainable growth. Although these rates will not reach those in the Far East or some other rapidly modernising national economies, they can still be considered substantial – even more so if the EMU leads to rather sluggish (if any) growth in the present EU in the first years.

Second, Europe is the master in yesterday's technologies (of mass production). But it is increasingly lagging behind in tomorrow's technologies. The loss of market shares in high-technology sectors and the concentration of exports in medium and low-technology areas is a clear proof of this process.

Third, unemployment, reaching the two-digit level, seems to be a lasting component of European development and integration. Employment-neutral growth, increased technology-intensive production and the emergence of a knowledge-based society are not particularly favourable factors for changing this trend in the foreseeable future in any European country. Substantially lower levels of unemployment would require a much more flexible labour market and, at least as important, a booming economy in Central and Eastern Europe.

Fourth, income gaps are emerging between different countries as well as within similarly developed countries alike. Economic and social polarisation (and marginalisation) may become a serious threat to sustainable stability and economic welfare. More importantly, increasing gaps between reality (the financial capability of a person or a family) and patterns transmitted by the globalising media (what a person or a family *should* acquire and possess) can easily create political, social and psychological problems. This is by no means a uniquely European problem, but due to the size of income gap, the geographic proximity and the level of general education, the conflict may first emerge seriously in this part of the world.

Fifth, ageing population is substantially changing the ratio between producers and consumers of national income. The social security and pension systems are becoming increasingly challenged during a time where growth is low and fewer people are expected to produce the same (or higher) level of GDP. However, this situation will change in about eight to ten years when Europe will be struggling with a shortage of manpower. Availability of manpower (wherever it comes from) will be a basic condition for financing social security and pension systems all around the continent. As a consequence, a much more careful and forward-looking employment policy must now be developed.

In addition to these disadvantages, Europe has the following advantages.

First, enormous economic power is accumulated in a geographically concentrated space.

Second, new growth regions are emerging, including in the central and eastern parts of the continent. Even if this growth will not be able to substantially change the outlook for Western Europe, it can essentially and positively influence business expectations. In the last few years, this market has already proved to be the most dynamic export market for the EU. Between 1992 and 1996, the share of the six CEFTA countries in EU's extra-regional exports grew from 5.8% to 9.2%, by far the highest increase in international comparison. In addition, in the same period, the EU has registered a trade surplus of ECU40.9 billion with the ten associated countries, i.e. almost 80% more than the total surplus from the EU's extra-regional trade. In other words, the associated countries fully financed the EU's trade deficit with other parts of the world. Although the EU may have used some of the benefits emerging from trade liberalisation without providing full membership for the Central and Eastern European countries, large benefits deriving from dynamic effects of intra-regional trade can still be expected for the years of membership.[3]

Third, the enormous cost difference in educated manpower is a unique potential of global competitiveness. Previously, international intra-industry trade and subcontracting were based on the huge wage differences in the unskilled and low-skilled labour market segments, and both the United States and Japan based their industrial relocation policies on this factor. Western Europe, never eager to go this way (due to enlargements by high-cost new members, additional temporary markets, non-availability of convenient labour in preferential trade areas), now has a historical chance to make use of the highly educated and flexible labour of Central and Eastern Europe. As the development of FDI in Hungary shows, this new pattern is already evolving on the micro-level as a result of rapid learning by multinational companies. In the longer term, it could substantially modify the well-known theoretical pattern of international division of labour among countries with different levels of economic development.

3 In turn, non-membership and growing trade balance problems may even jeopardise the already achieved level, and this could have a serious negative impact on the EU's overall growth, trade and, indirectly, also on European security.

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Fourth, investment in environment is likely to create a qualitatively higher demand, leading to economies-of-scale production of many technologies and commodities. This may offer Europe a competitive edge in the global marketplace.

Fifth, a potential contribution to Europe's global advantage of Central and Eastern Europe may be identified in its higher institutional and social flexibility as proved in the first years of transformation (provided that this feature will be sustainable in the next period as well).

Sixth, while higher social standards may provide additional advantages such as social peace, more even income distribution and a wider tax base, it is not entirely clear to what extent they can be financed, and how the basic framework of the 'social market economy' can survive in an increasingly competitive international environment. In addition, higher social standards in Central and Eastern Europe may increase the cohesion of the continent and facilitate the accession process. On the other hand, however, such a development may also be counterproductive, if too high and too rapidly introduced social adjustment to EU standards results in loss of competitiveness, declining growth rates and growing unemployment.

VI Regionalism in Europe, For What?

One option of European regionalism is the establishment of a fortress Europe. It can consist of the present EU members and exclude all other European countries, or even include some of the candidate countries and let them participate in an extended fortress. Both options tend to threaten Europe's global position.

Only an open European regionalism can be supported, and the candidate countries are very much interested in such a development. At present, Europe is open to different degrees in selected areas. Trade and services are relatively open and are likely to open even more as a result of the WTO negotiations. Capital markets are widely open and no national or EU-level initiative could substantially change this feature. On the other hand, labour markets are highly protected, and high unemployment only tends to increase the level of protection. This could, however, prove extremely counterproductive since capital would leave labour market-protecting countries more rapidly in search for competitive locations and production all around the globe. Finally, a change in mentality is needed, mainly in Western Europe. Almost one decade after the fall of the Berlin Wall, status quo mentality still seems to prevail. There is widespread fear of other ideologies and different social attitudes and patterns. These fears encompass not only Islam fundamentalism and Eastern orthodoxy, but they also include increased flexibility and lower social standards represented by countries which were historically shaped by Western (European) civilisation.

More open regionalism in Europe, including institutionalised regionalism in the framework of an enlarged Union, will not necessarily have negative effects on those countries and groups of countries with which the EU has had lasting and contractually established relations. First, if there is a crowding out of some (mainly African) countries, it will not be the result of EU enlargement since the trade pattern is completely different and, in most cases, Africa, the Middle East and Central and Eastern Europe do not compete for potential investors. On the contrary, since the new members have to accept the EU's system of international trade relations, all EU partners will have a larger market for their products and also a larger volume of financial and technological support.

Until now, benefits and threats (costs, risks) of open regionalism in Europe have not been carefully studied. A higher level of openness brings substantial economic benefits (for efficient competitors) but it can also be accompanied by new security threats. Will the latter be smaller or larger than the net economic benefits? Or, will economic benefits of openness be larger than the loss registered by non-competitive sectors and firms? Can the latter be compensated in order to sustain internal stability? How can openness be enhanced and sustained if some fundamental structural changes become unavoidable (e.g. change of social welfare system, mentality and status quo attitude). Earlier, such exercises were carried out in a relatively closed economy and society, and opening up was the consequence of successful domestic restructuring. This sequencing, however, is hardly possible today since any delay in opening up can easily lead to marginalisation (of course in itself, opening up is no remedy against marginalisation either).

It is the dilemma of the candidate countries that they are policytakers in Europe. Viable alternatives to EU membership can hardly be envisioned, even if some experts have already raised the issue of a more diversified external economic orientation. Higher growth in Asia and North America, technological advantage of non-European countries and huge potential financial resources outside the 'old continent' have been suggested as reasons, but geographic, economic, social and cultural realities would allow such an 'adventure' only within a rather narrow scope – if at all. Certainly, small, vulnerable and world economy-dependent countries have to do everything to shape diversified economic relations but not by ignoring or rejecting obvious realities. The integration of the Central and Eastern European countries into the EU can be viewed as a stepping stone to more global involvement, both in security, political and economic terms, but here, again, the 'geographic sequencing has to be observed.

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VII The Future of Regional Cooperation in Europe

There are two basic geographic shifts already taking place in Europe, and both are likely to become even stronger in the next few years as a result of the eastern enlargement of NATO and the EU. The first shift means the inclusion of a second sea into the 'empire of mare nostrum' of Europe. Besides the Mediterranean, the Baltics are becoming a 'European territory'. This shift can be characterised as a South-North shift, which already started with the last enlargement of the EU to the North. The second shift is from the Atlantic coast towards the geographic core areas of the continent – a West-East shift. Both of these shifts will fundamentally shape the future pattern of regional cooperation.

Another important factor of regional cooperation is the emergence of new growth centres all over the continent. They are likely to develop in the following areas:

- transborder cooperation between and among highly developed EU member countries;
- cooperation between regions with different levels of development, also supported by EU funds;
- catching up countries of Central (and Eastern) Europe with relevant growth potential;
- special geographic position of some candidate countries. One has to remember that the first wave of eastern enlargement will integrate countries into the EU that do not represent the geographic periphery of Europe (all the four earlier enlargements included peripheral countries). In geographic terms, they are located between Western and Eastern (Southern) Europe, and can be considered gateways to other emerging markets. As a result, the multiplier impacts of the geographic factor of eastern enlargement are not comparable with those of earlier accessions.

In the longer term, economic relations in general, and intra-industry trade based on competitive costs in Central and Eastern Europe in particular, may have a sensible influence on the global competitive position of the present member countries. Those countries (and firms) that are already widely using the production cost differential in their investment and production policies and created a subcontracting network in the candidate countries, are likely to enjoy comparative advantage vis-à-vis those countries (and firms) that have not yet been involved in such activities. As a result, different levels of engagement in Central and Eastern Europe may influence the competitive position of the individual EU member countries differently. Provided that the affected EU countries are members of the EMU, relative changes in their competitive position will necessarily lead to the use of policy instruments to correct this distortion. As a consequence, shifts within the European balance of economic power cannot be ruled out.

VIII Concluding Remarks: Challenges Ahead

It is certainly true that Europe influences global trends, but the future of regionalism in Europe is also increasingly shaped by external factors. In this context, the role of non-European capital (mainly from the US, Japan and other Far Eastern economies) can be decisively important. We do not currently know to what extent non-European actors would like to intervene into the process of (open) regionalism in Europe. Their interventions – and Europe's response to them – will depend on the specific area under discussion. This is well illustrated by the US which tends to intervene when security and trade are concerned, but is less inclined to intervene with regard to capital flows. US intervention may even produce conflict when issues of culture or mentality are involved. Although Europe's place in the sun in the 21st century must be mainly defined by Europe itself, non-European strategies and interests will have to be considered. Non-European strategies may not only contribute to Europe's future role in the world economy but also to the intra-European pattern of balance of power and of cooperation, and Central and Eastern Europe will become an integral part of this development.

The impact of intra-European developments during the next decade will be equally important. In all countries, the 'war generation', who personally experienced the cruelty and irrationality of war and its painful consequences, is stepping down in the next couple of years. They will be replaced by a new generation which, in Western Europe, acquired its basic 'life philosophy' in the post-war decades which were fundamentally shaped by the integration process. As the main beneficiaries of a Western European integration process which produced peace, stability and welfare, will this generation be the carrier of an even stronger and deeper integration of the continent, or will their priorities be changing due to new challenges and concepts?

One of the biggest conflicts may emerge between economic necessities and the established political system. Such a conflict can become manifest in three areas.

First, the current political system, as the 'superstructure', should meet the requirements of a mature, developed market economy based on industrial (mass) production. The world, and also Europe are rapidly moving towards a knowledge-based economy and an information-led society. Is the inherited political system appropriate to cope with the new challenges or will it increasingly become a barrier to economic and social restructuring?

Second, the whole of Europe (and not only the transforming countries) is already facing the challenge of modernisation. In the last fifty years, the security map of Europe and the predictability of economic (and social) development within the framework of a developed welfare state did not put overall and sweeping modernisation on the agenda. Now, however, the pressure of economic, social and mental modernisation can hardly be delayed any further. Unlike 'normal' times, the time frame of modernisation does not necessarily overlap with the four-year cycle of the inherited political structure. Is the present political system flexible and stable enough to adjust to the challenge of modernisation and, at the same time, define and defend the key elements of successful modernisation over one, or maybe more than one, four-year election period?

Third, future mainstream politics may be increasingly defined by older people who are less interested in modernisation plans overarching two generations, but in maintaining their status quo. With a continuously increasing share of older people among the citizens entitled to vote, this danger becomes greater. In this context, the whole electoral system of the European democracy may be defied.

Obviously, the construction of a new Europe, with widening European integration as its core element, needs a clear strategy, a transparent time frame including gradualism and 'geographic sequencing', patience, bold measures, innovative politics, forward-looking politicians – and also some luck offered by history. It should not be forgotten that there will be a lot of sensitive issues damaging the short-term interests of various countries, sectors, regions and lobbies. The balancing out of such conflicts with different instruments will become a major strategic issue. In this context, the original idea of solidarity and social cohesion of European integration has to be extended to the whole continent. Few things would be more destructive than the application of a double standard between 'ins' and 'outs'. Unfortunately, there have been some evident efforts in this direction in the last years (partial membership, exclusion of new member countries from financial transfers, second-class membership, etc.). Everybody is aware (or will be aware soon) of the fact that the Europe of the future has to be different from the Europe of the past. Vested interests of the present member countries cannot be fully defended since expected benefits of would-be members based on the past system of integration have to be revised as well. However painful, equal footing can be sold in Europe. Any other approach, even temporarily, would undermine not only trust and confidence in Europe but, as a direct consequence, also stability and global competitiveness.

Transition and Integration in Central and Eastern Europe

Hans Peter Lankes

I Introduction

At about $3,200 per capita in 1997, incomes in the accession countries of Eastern Europe are far below the EU average. Nevertheless, incomes are rising fast. In 1991, per capita GDP was at $1,900.[1] But it is important to note that the conditions for EU accession have not been formulated in terms of per capita GDP. If we look at the accession criteria defined at the Copenhagen Summit in 1995, the economic aspects of those criteria look very much like a test of success in the transition process, i.e. they define what we mean by the development of a competitive market economy.[2] Thus, we conclude that furthering the transition process would also further a country's chances of accession to the EU. What does this mean?

In our view, the countries of Central Europe and most of the countries of the former USSR are already market economies in that most economic decisions are made on the basis of prices that are determined by demand and supply, and often by competition from (and entry by) foreign providers. Thus, markets are generally liberalised, but what is lacking – and this is true throughout the region to varying degrees – are some of the ingredients that make markets function well. These include, among others, public and private institutions and behaviours. Before I turn to these topics, let me present some evidence about the existence and effects of markets in the region.

1 Between 1991 and 1997, real GDP was virtually constant, so the effect of real appreciation has been significant.

2 While the conditions for successful transition and for meeting the requirements of membership of the EU are similar, the latter also embody a large number of very detailed and demanding obligations which go beyond my topic here. Some of these require the strengthening and adjustment of public institutions, as for instance in the regulation of product standards or of competition. Others will have strong implications particularly for investment in infrastructure, enterprises and financial institutions.

II Progress towards Market Economy

One way of assessing the effectiveness of markets is by measuring the extent and direction of structural change. The centrally planned economies differed significantly from western market economies in the relative size of their industrial sectors, and in relatively underdeveloped service sectors. Employment shares are one important measure of structure. In an EBRD study we have estimated a benchmark share of employment, based on 41 industrial and developing market economies, for different economic sectors. After adjusting for income, in 1989-1990 the share of employment was 36% in the industrial sector in Eastern Europe and former Soviet Union compared with the benchmark value of 23%. By 1995, the actual share of employment in the industrial sector had fallen to 28%. Since incomes fell in real terms during that period, the benchmark fell and the gap has not diminished, but there has clearly been a sharp movement towards what we would consider a market-determined size for this sector. There is movement in the opposite direction for market-oriented services (excluding education, health and similar government provided services) where the employment share increased from 21% to 24% and has actually overshot the benchmark which has fallen as a result of the contraction in income. The point of these comparisons is that they demonstrate that markets have had a very powerful effect on economic structure. This is one good reason why we should view these countries as being market economies. But can we say a bit more about the quality with which these markets function?

At EBRD, we produce an annual measure of how countries progress along several different dimensions of transition including: privatisation; the restructuring and governance of companies; liberalisation of prices, trade and foreign exchange markets; banking sector reform; securities markets and other non-bank financial services; and competition policy. We define what constitutes a market economy in terms of the mechanism that guides economic decisionmaking, and we assess how countries perform based on progress on the different dimensions.

We rate performance on a scale of 1 through 4 where one is the level where all of the countries more or less began – though Hungary and Poland may already have been more advanced – and four represents a market economy. According to this measure progress has been strongest in Central Europe and the Baltics. Despite some variation, the candidate countries have performed rather well in our view in terms of the averages across all of the dimensions as we defined them.

But the country averages do not tell the full story. We can divide the different reform dimensions into those where the government must stop doing

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something – e.g. stop controlling prices, stop owning and controlling companies – and dimensions where the government or private sector must take action to design frameworks in which markets function well, e.g. promote business standards, ensure the soundness of financial institutions and capital markets, enforce creditor rights and product standards, maintain competition. The performance of the countries has varied widely across these two types of reform, individually and averaged as a whole. Performance has been far weaker on those dimensions where the government has to take concrete action. These deeper institutional and behavioural issues are important dimensions of transition, going beyond the passage of the required reforms by legislatures. However, change of this nature is also very complex. Since it involves fundamentally a learning process, it does not depend on simple fiat but draws on the gradual build-up of experience and therefore requires time. It is precisely here that the most important advances are required before these countries would be ready for accession to the EU. We can discuss these under the headings of government and enterprise capacity.

III Government Capacity

Government behaviour affects enterprise performance and growth in two fundamental ways. The first concerns uncertainty about government policy (such as taxation and tariffs) and unpredictability of actions by the government and judiciary, both of which can lead to the postponement of investment and to short-term horizons for business decisions. The second stems from the state (the government, bureaucracy and judiciary) operating in a highly discretionary manner and thereby generating inefficiencies through the seeking and granting of special privileges and by stifling entrepreneurship altogether. In both cases, growth is inhibited because investment in existing enterprises is reduced, entry and growth of new firms is hampered and foreign investment is deterred.

Throughout the region, we witness a series of weaknesses of the state. It is more extreme in some cases such as the former Soviet Union where the central government was virtually destroyed when the communist party was destroyed, and the normal state institutions have had great difficulty reforming and recreating themselves. In the following I discuss just three examples of weak state governance, taxation, corruption and subsidisation, but it should be clear that problems exist in many areas in which state institutions (should) play an important role for market activity.

The most prominent example of government activity where good governance is crucial for the functioning of a market economy is taxation. Taxation is one of the biggest problems facing foreign investors in a number of countries in the region, particularly in the CIS but also to some extent in the accession countries. The problems lie not in the existence of taxation but in its design and functioning. In practice, it often involves definitions of tax bases and rates which, if applied literally, could drive the honest tax-payer out of existence (for example, definitions of profits which make no allowance for a number of substantial and genuine costs[3]). The result is widespread discretion by both ministers and revenue officers and a plethora of special deals and exemptions.

Corruption is another crucial problem that exposes the states' weaknesses. According to a variety of surveys, corruption levels in the CIS are perceived as being the highest in the world. Those in Eastern Europe and the Baltics are not as extreme but still rank relatively high compared to, say, Southern Europe. Corruption has a particularly strong deterrent effect on market entry by new operators. There is much that sound institutional and policy design can achieve in promoting responsible behaviour and limiting corrupt practices. Government structures should, as far as possible, limit the number of licences and permissions required and the discretion of civil servants over the ordinary economic activity of entrepreneurs and consumers. It is when permissions or discretionary decisions start to permeate throughout the economy and society that bureaucratic interference develops and the potential for corruption grows. There is a great deal also that private firms and financial institutions can do to limit corrupt practices.

An additional state weakness lies in the governance of state enterprises and banks, for instance in government provided soft-budget constraints. Beginning in 1990, direct budget subsidies were cut to levels quite low and comparable to Western Europe. But at the same time, a process of off-budget subsidies evolved through the banking system and tax arrears which compensated enterprises for the loss of financial backing by the government to some extent. Non-performing loans on which no action was taken and tax arrears have both stopped increasing around 1994 so we deduct that this element of softness has receded in the Central European applicant countries and the Baltics. Nevertheless, energy and fuel prices continue to be far lower than in the EU countries – providing implicit protection – and there remains a large variety of technical barriers to trade which will have to disappear as the pre-accession process advances.

IV Enterprise Capacity

In our discussion of governance so far we have emphasised the behaviour

3 These definitions can be particularly pernicious in an inflationary environment.

and practices of government itself. But effective governance requires the cooperation and participation of the governed. In particular, in economic affairs it requires sound business practices in enterprises. Sound practices may be expressed in terms of those practices which implement long-term profit maximisation for the benefit of shareholders (including minority shareholders) while maintaining and developing good and honest relationships with those with whom the enterprise interacts. They also imply the ability to restructure to adjust to market circumstances. Such principles are not yet widely and immediately understood in transition economies. Indeed, it has taken many decades (running into centuries) for them to be established in more advanced market economies. However, it is crucial that these practices become established quickly in transition economies.

The governance of most medium-sized and large enterprises in Eastern Europe requires dramatic change. Privatisation represents a first step, but the form of privatisation (involving a number of compromises) has not, in most cases, provided effective governance. There are a number of methods of privatisation. Hungary and Estonia have used sales to outsiders as their primary method of privatisation; five other countries have used equal access voucher privatisation; three have used voucher privatisation with insider concessions; and nine used management-employee buyouts as their main method of privatisation. Theory and practice will tell you that the latter methods are most likely to compromise corporate governance in a period where enterprises need access to external resources to implement large scale, deep restructuring. Employee-owned funds will have more difficulty coping with such structural pressure than those acquired by strategic investors from outside.

Following privatisation, therefore, change is often required in the ownership structures and in the methods of corporate governance. Instrumental to this change will be development of the financial sector to provide an effective source of outside finance for investment and a market in which changes in ownership and control can take place. In several transition economies, however, including some of the accession candidates, lack of transparency and deficiencies in the codification of shareholder rights have allowed the financial sector to act as a brake on the establishment of sound governance.

V Conclusion

Following the rapid liberalisation and privatisation of the earlier years of transition and the impressive progress in macroeconomic stabilisation, growth is returning in the region as the transition is entering a new phase.

Most countries of the region are already market economies in some shape or form. The central challenge of the current phase of transition is building the governance and institutions which will underpin a well-functioning market economy. This is also the key challenge in promoting sustained growth and in preparing countries for EU accession. It will be governance and institutions that deliver effective and competitive markets which in turn deliver restructuring and sustained growth.

The Challenges of EU Accession in the Baltics

Piritta Sorsa[1]

I Introduction

The challenges of EU accession in the Baltics are closely related to the challenges of transition. While all three Baltic countries have made substantial progress in macroeconomic stabilisation since the beginning of transition, a number of structural challenges remain. The key criteria mentioned by the EU in *Agenda 2000* are a functioning market economy and an ability to cope with competitive pressures and market forces. This means that the applicants are not only expected to adopt EU policies, but they must also be able to enforce them so that companies on both sides can compete fairly. In practice, this means that there must be more progress in structural adjustment toward a market economy.

II The Maintenance of Successful Stabilisation

All three countries have made considerable progress in stabilising their economies. Inflation is down to nearly single digits. Growth resumed a number of years ago, reaching nearly 10% in Estonia during some quarters of 1997. Fiscal deficits have been small ranging around 0-2 percentage points of GDP, and exchange rates have been stabilised within currency boards (Estonia and Lithuania) and a fixed peg (Latvia to SDR). Foreign trade and most prices have been liberalised. In trade policy, Estonia is the most liberal with a practically restriction-free trade regime. All three countries have redirected trade from the East to the West. Again, Estonia has been the most successful with about three quarters of its exports now going to countries outside the former Soviet Union. Foreign direct investment (FDI) has increased in all three but the increase has been greatest in Estonia. Estonia's cumulated FDI per capita was $538 in 1996 compared to $256 for Latvia and $102 for Lithuania.

1 The views presented are solely those of the author and do not necessarily reflect those of the International Monetary Fund or its Board of Directors.

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The Baltics are facing at least three main issues which influences their ability to maintain their positive performance. First, all three are struggling with relatively large current account deficits, the largest one being in Estonia of over 10% of GDP. Closely related to this is concern about competitiveness in an environment of fixed parities, large capital inflows and several years of high inflation. A number of indicators on the sustainability of current account deficits suggests that while the deficits are high, they may be manageable since they reflect mostly private sector imports related to transition. Furthermore, exports in all three have been growing, and real interest rates have continued to decline indicating confidence in the parities and maintenance of competitiveness of exports. Many of the imports are capital goods related to investments, which should generate income to pay for the deficits. Also, much of the price adjustment seems to reflect price arbitrage and increased productivity growth in the tradable goods sector. However, the recent growth of credit and increases in shorter-term foreign borrowing by banks calls for vigilance, especially in Estonia. The tightening of monetary conditions (increases in banks' reserve requirements) in 1997 is likely to slow demand for credit to prevent overheating. This also underlines the importance of proper credit risk assessments in the banking sector so that the capital inflows are invested wisely.

Another challenge lies in the fiscal area with the role of the state. All three Baltic countries face the challenge of designing an appropriate role for the state in a modern market economy. Although government involvement in the economy has been successfully reduced in many areas of economic activity, developing the activities of the state in areas where it should play a role remains a challenge. These areas include many regulatory functions such as competition policy and environmental regulations, and it is important for the Baltics to bring their policies and regulations up to EU standards. Also, the relatively high share of government expenditures in GDP calls for rationalisation of public sector activities.

The third challenge is the creation of incentives for higher savings rates. This is closely related to pension reform and a reduction of public expenditures. Savings rates have also been relatively low in the Baltics – between 13-16% of GDP – compared to other emerging market economies which often have rates between 20-30%. All three countries need to make more of an effort to mobilise savings to finance future investment needs for higher growth.

III Structural Reform

The remaining challenges are primarily in structural reform, and this seems to be the area in which the European Commission differentiated between Estonia and the other two Baltic countries. Key areas for further reform are privatisation and private sector incentives, restructuring of enterprises, financial sector reform and environmental regulation. One indicator used by the Commission concerning progress in structural reform and the ability to withstand competitive pressures was the degree of diversification of the export base in the applicant economies.

The EU expressed some concern that the weak export bases in Latvia and Lithuania indicated a slow restructuring of industry and a slow implementation of market reforms. Most of the Baltic countries' exports are still resource-intensive goods with low value-added. In Estonia, statistics indicate some intra-industry trade in textiles and some machinery products. A lack of diversification in Latvia and Lithuania may reflect higher protection levels in some activities (especially agriculture), but it may also reflect high protection of value-added in goods produced by local industries. This would tend to keep resources in protected activities at the cost of developing export industries. Progress in privatisation and private sector incentives is also an important factor for developing a dynamic export base.

Privatisation needs to proceed further, especially in Latvia and Lithuania; Estonia is most advanced in this respect having completed privatisation in all but a few utilities and infrastructure facilities in its economy. In Latvia and Lithuania, privatisation of both large- and small-scale enterprises needs more progress. Restructuring of (the privatised) enterprises is another area where more progress needs to be made in Latvia and Lithuania. In this area, Lithuania seems to be lagging furthest behind, but this may reflect the nature of privatisation undertaken there. Compared to direct sales to new owners, new managers in management buy-outs tend to be less willing to restructure privatised enterprises. And since management buy-outs have been the most common form of privatisation in Lithuania, this may explain their slower progress in restructuring.

Private sector incentives is another area in which all three, but especially Latvia and Lithuania, need to make additional progress. This includes policies such as regulations on entry and exit barriers to enterprises (especially bankruptcy procedures, right to establishment), enforcement of property rights (land ownership, the legal system) and infrastructure development. In Estonia, private land ownership and bankruptcy procedures have been in force the longest.

Financial sector development is another area of importance to transition calling for further reform. An efficient financial sector is essential to allocating foreign or domestic savings to most efficient uses. This is especially important to channelling large capital inflows into productive uses to prevent an unsustainable debt build-up or reversal of capital flows. In Latvia and Lithuania efficient banking may be somewhat impeded by the existence of a non-performing loans in the banks' portfolios. Also credit and risk assessment tools need to be developed further.

IV Challenges for the EU

The EU can assist the transition of the Baltic countries by keeping its markets open. Despite apparently liberal trade agreements, a number of sensitive goods from the Baltic countries remain subject to trade restrictions by the EU. These include agricultural and fish products and textiles which together account for about a third of Baltic exports. Furthermore, trade in services is outside the scope of the agreements, and the Baltics may have some comparative advantages in this sector. Since all three Baltic countries are highly trade dependent (exports account for 30-60% of GDP), conditions of market access for their exports are vital for in transition and growth performance.

Another area in which the Baltics would welcome action from the EU is reform of its agricultural policies. Currently, the Baltic countries are less protectionist in agriculture than the EU. Joining the Union would mean an increase in protection in the agricultural sector with negative efficiency implications for resource allocation. High protection in the EU might create an expectation in the Baltic countries of higher future protection, and this could reduce incentives in the Baltics to develop efficient agriculture.

An additional area where the EU could provide help is technical assistance in drafting the necessary laws required by accession.

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Floor Discussion of "The New Europe"

Competition and Trade

Arvind Panagariya began the discussion by commenting that while under the association agreements the Central and Eastern European countries (CEECs) have already opened their markets to the EU, the reverse is not the case in products such as steel, textiles and agriculture. He wondered whether the EU feared competition from the CEECs.

Henk Post, head of cabinet at the European Commission, responded that the Europe Agreements are, on the contrary, asymmetrical and in the CEECs' advantage since EU borders will open to the CEECs much earlier than the other way around. "There is no evidence nor any reason for the EU to fear competition from the CEECs on agriculture or in any other field, nor is our policy based on any such fear. However, if you study the structure of agriculture in some of the candidate countries, you can see that an enormous amount of work needs to be done in order to enable them to compete in the internal market. In most of these countries, there is insufficient regulatory structure for veterinary control, BSE prevention, and numerous other consumer protection measures. Several billions of ECU have been reserved by the EU to finance the restructuring of agriculture in the CEECs to enable them to adjust to the EU agricultural policy more easily and to overcome the enormous problems in terms of stocks, food safety and pricing which they would have if they do not restructure."

According to András Inotai, the EU is afraid of competition in areas other than the so-called sensitive areas of textiles and agriculture. "The real fear of competitiveness on the part of the EU is in the highly-skilled industries in which we are competitive. This is the challenge which has not been reckoned with in the mentality of Western Europe. Competitiveness in the next century will be based on the competitiveness of societies and institutions. In this sense, Central and Eastern European countries are in a good position as a result of the transformation process."

Inotai also responded to a question from Andrew Cornford on the competitiveness criteria in relation to exchange rates, "Once a candidate country becomes a member of the EU, it will become a member of the EMS-2 and not the EMU. As a result, it will have very limited autonomy in terms of its exchange rate policy. The national currency will be linked to the Euro and there will be a certain margin of fluctuation. The question is how

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large the margin will be. I think there will be an appreciation of the currency of the new member country, but this will be offset by occasional double-digit annual growth of productivity."

Piritta Sorsa disagreed with Henk Post's statement about asymmetry and referred to the impact of EU quotas on investment in the Baltics. "In the case of Estonia, there is no asymmetry. Estonia gave free access both in manufacturing and in agriculture, and the EU is restricting agriculture quite a lot. Another point is whether the fact that quotas are not fulfilled is a sign of openness or restrictiveness. When one has quotas or even surveillance of a product, it does affect investments because it is an uncertainty for investors in market access. Statistics show that in the Baltics, most FDI has gone to services or to industries that do not export to Europe, so there is very little investment that would be geared to the European market."

Arvind Panagariya turned the discussion to trade. "The point was made that at the moment, many of the countries in Central and Eastern Europe are not interested in joining the EU, nor are they ready for it. From an economist's perspective, that is rather odd since the gains from trade are available to all countries regardless of whether they are rich or poor. This philosophy has also been behind the advocacy of trade liberalisation from the IMF and the World Bank."

Henk Post responded, "I would like to stress that the EU is not a free trade area. The EU is a Union which has an *acquis* and an internal market and this goes much further than just a free trade area. We need to avoid a situation where enlargement results in a pseudo free trade area which would weaken what we have achieved over the years."

András Inotai followed up on the issue of trade and asymmetry. "Except for agriculture, there are really no trade barriers for CEEC exports to the EU. Whether and to what extent this temporary asymmetry has provided advantages is another question. The gap was not a trade gap but a development gap, a historical legacy which can hardly be compensated by 5 years of temporary asymmetry. It helps, but it will not contribute substantively to changing the development pattern."

He continued with a spirited account of the recent dynamism of East-West European trade relations. "There was no other bilateral trade relationship in Europe which developed more dynamically in the last 5 years than trade relations within the CEECs on the one hand and between the CEEC and the EU on the other. Hungary is currently ranked higher than 5 EU member countries in exporting finished manufactured goods to Germany. Almost 50 percent of Hungarian exports consists of machinery, computers and transport equipment, while 5 years ago this share was only 13 percent. This is a tremendous change. All of this is certainly supported by foreign direct investment and restructuring. In addition, MNCs have started sub-contracting in research and development activities because we have some comparative advantages in this area. Our comparative advantage is not only in the area of unskilled labour. In contrast to the 1970s and early 1980s when the international division of labour between the US and Latin America and between Japan and Southeast Asia was based on a pattern of unskilled labour, the division of labour in Europe is based on educated, skilled labour. This is the real challenge for Western Europe."

EU Institutional Reform and Policies

Stephany Griffith-Jones asked Henk Post to elaborate on the EU's plans to begin negotiations for a Free Trade Area with Mercosur and Chile and also possibly with Mexico. Post responded that while some member states viewed these upcoming negotiations as far too liberal, he believed it would have a positive impact on the EU's position in global terms.

Percy Mistry suggested that the European Commission was overloading its administrative circuits "by going for extremely complex programmes of deepening followed by widening, and raising too many issues simultaneously. The budgetary machinery of the member governments may not be able to handle this either. How does the Commission see this problem of circuit overload and if the circuits trip, what is going to be the trade-off priority? Will it be the EMU, which will probably be complete in 3 or 4 phases instead of 2? Will it be the reform of the Common Agricultural Policy (CAP) and the structural funds? Or will it be something else?"

Henk Post did not believe that the EU's circuits could easily be overloaded. "We have, on the one hand on purpose, put all of the political decisions in one basket because we know from experience that this is the only way to get difficult decisions through at the highest political level in the EU. If we would go piecemeal and give one element out of the package to the Council every so many months or years, it would result in a very long-term and painful process that would probably end up in a blockage.

But there is another more practical reason and that is that all of the elements that we put in our package need to be dealt with at the same time. The current structural funding regulations expire by the end of 1999, so they have to be reformed and renewed. In agriculture, beef and cereals stocks will increase from the year 2000 to 2001. In order to have the necessary reform to avoid this, evidence shows that we have to start about 18 months in advance. So we have to put forward proposals for reform in these sectors. There is no way around it, it has to be put all together and it will result in an complicated package which has to be agreed upon. On top of that, there will be institutional reform within the EU itself. We will certainly have a new intergovernmental conference to deal with institutional reform within the EU in a couple of years' time, as the Commission has proposed, before the first enlargement takes place. The closer we get to the first new member coming in, the bigger the incentives are for the present members to agree to institutional reform."

Salvatore Zecchini inquired as to what kind of parallelism was envisaged between the conditions required for the new candidate countries and the reform of the EU's internal institutions and policies.

Henk Post responded that in the circles of the Finance Ministers and the heads of state, the main focus was on the internal reform and on the financial framework for the coming years. "The negotiations with the CEEC will begin with a screening phase and this will be followed by a phase of working through the entire *acquis* of the internal market and the *acquis* of other related internal policies. The main spending policies, agriculture and structural funds will be dealt with at a later stage. It is only logical that member states, in presenting their common positions, will concentrate on the *acquis* phase for the negotiations with the CEECs and leave enough time for discussing and negotiating the other policies later on. Another reason I think that it will happen like this is that there is no other way to do it. We have to define the financial framework for the coming 7 years, the expenditure of the CAP and the expenditure on structural funding within the Union."

Enlargement and Adjustment

The implications of enlargement for Third World development was the subject of a comment by Bertil Oden. "Specifically I am interested in the Union's attitude toward the Third World in terms of aid, and the attitudes and values of the negotiations now on the agenda in the post-Lomé negotiations. We have one example in the ongoing EU-South Africa trade agreement where it is reported that some member countries in the EU have requested exemptions on products which are not produced by South Africa but which are produced by Eastern Europe."

Percy Mistry was also interested in this issue and gave an example. "When it comes to widening, we had this disingenuous argument in 1990 where all of the donor countries, but particularly the EU countries, assured the developing world that any aid flows to the CEECs would be additional. There is ample evidence now that there was no additionality. In fact, there was a direct diversion of aid from traditional recipients to non-traditional recipients. Now if this 75 billion ECU that has been suggested by the Economic Commission is a serious proposition, what will the potential impact be, especially on the countries south of the Mediterranean and on the eastern rim of the Mediterranean which could be in a competing situation or a conflict of interest situation for resources?"

Mistry also wondered whether the EU membership carrot was not being dangled prematurely, "And if so, what is the political motivation behind it? There can be dangers in dangling incentives so far in advance that they almost seem permanently out of reach. How do both sides see it and what are you going to get out of this?"

Henk Post agreed with this last point. "It is indeed one of the dangers in this entire process that expectations are raised in public in an age of media-driven politics while, in reality, quite different matters on a different level of ambition are being discussed. There are two sides to this issue. One is that I hope that the Luxembourg Council which will convene in December of this year will agree to the proposals that the Commission has made and will set them in stone. This will remove some of the unrealistic expectations that have been raised in the past. At the same time, however, it is very important for the political leaders of the candidate countries not to raise expectations there either. Enlargement is a process of motivating the populations of the candidate countries for the very painful economic reform they will have to go through in order to become a member of the EU. It is not a very popular political platform to take, but it is a necessary one to take in order to make the process succeed."

Janos Gács pointed to the fact that the costs for the EU of opening up to Central and Eastern Europe and acquiring new members from this region tend to be exaggerated. "In fact, in the last year I see an ever growing gap between the understanding of enlargement by politicians and by scholars. Let me just give two examples. The first is from Austria where I work and have been fortunate to be able to follow their approach. From the beginning, Austria has been very supportive of opening up and transition. They have given a lot of support in terms of technical assistance – some have even talked of a re-emergence of the Austro-Hungarian monarchy. However, in the past year, there are signs of a change in the public attitude, and a number of politicians and public speakers have spoken out against enlargement. They speak of the threat of enlargement on their industries, on employment and they would like to postpone enlargement for as long as possible. My second example is that in 1997, a committee of the European Parliament argued that Poland's large agricultural sector might pose a problem for the EU, and then the Parliament leaked out the results of some calculations of enlargement which were way off line from the calculations of scholars. What the major scholarly works about enlargement boil down to is that enlargement requires profound adjustment in CEECs and will lead to negligible costs to the EU."

András Inotai elaborated on the issues of adjustment and misleading perceptions. "Everyone knows how painful and difficult the process of

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adjustment to EU standards is. But the last 6 years and the tremendous adjustment that has already taken place is a good indication that most of these adjustment criteria can be met if the reform dynamic can be maintained. We should be careful about making unjustified generalisations. The 10 CEECs cannot be put into the same basket, there are substantial differences between them. None of the EU policies or strategies suggest that these 10 countries will be taken as members at the same time, and all of those calculations and generalisations which view those 10 countries as a homogenous group are fatally misleading. It is not true that the countries are not competitive. They have different levels of competition and different institutional capabilities, and we know where the deficiencies are. In some areas, some of the transforming countries are ahead of Western Europe. I would not like for these countries to be measured by a double standard. It has a very negative psychological impact, it backfires in politics and it will certainly not increase either confidence or stability in Europe.

With regard to unemployment, it is a global issue. Even if there were no exports by the CEECs to the EU, the global challenges would require adjustment in the labour market in Western Europe. Up to now, East-West trade has created more jobs in Western Europe than in Central and Eastern Europe. The huge trade surplus is proof of this. As for migration, I do not see this as an important issue since, in many sectors, the labour demand in Western Europe is different from the labour supply in Central and Eastern Europe. Moreover, a recent survey in Hungary indicated that 1 percent (50,000 people) of the economically active population would be interested in migrating and another 2 to 3 percent would like to work in the EU for a couple of years. So the ramifications of this issue have been exaggerated."

Janos Gács emphasised that the cooperation between Eastern Europe and Western Europe in the last 7 years has provided a useful practice field for globalisation for both sides. "In fact, from the establishment of bilateral cooperation agreements between the various countries to the association agreements, these countries are learning how to open up their markets to the rest of the world as well. First, they opened up to Western Europe and then they established controlled relations with the rest of the world. Next, they attained WTO and OECD membership which also had some implications for their relationship with the rest of the world and for understanding globalisation. This adjustment also had a component in Western Europe. Western Europe has had to adjust to the challenge of coping with a surge of trade from the CEECs. When the CEECs become members, another phase of negotiations will follow, and this phase will again create a new practice field."

Hans Peter Lankes took up the issue of investment costs of acceding to the EU. "If one looks at the structure of investment needed to meet EU directives, one finds that the vast majority are investments in the environmental sector. In addition, investments should be made in the transport infrastructure even though this is not required for accession.

On the environmental side, out of the 60 to 80 billion ECU that is currently being suggested to meet European directives, about 40 to 50 are related to municipal environmental infrastructure, such as sewage and waste infrastructure. While I would not expect this to be made a condition of entry, I would expect it to be made an issue of a longer transition period. For the rest, there is a great deal of investment required in sectors such as heavy chemicals or power generation to change processes in order to meet both environmental as well as health and safety standards. If you look at what is happening in the region, a lot of this investment will happen anyway, accession or no accession, simply because of the process of modernisation of these industries. In many countries, investment in manufacturing and power generation as well as in other sectors, has been put off for years, but it is now picking up. Many of these facilities are reaching the end of their useful life and one would expect increases in investment as a result of a normal process of modernisation – and not simply to meet EU directives.

At EBRD, we have done some estimates of incremental investment needs taking sequencing needs into account, and we have come to the conclusion that between 1997 and 2002, it would amount to something like 5 to 5.5 percent of GDP, and between 2002 and 2012, taking into account increases in GDP in that period, it would fall to 4 percent or less. After 2012, it would be somewhere in the range of 2 to 3 percent of GDP. I think this is a point worth making because it is often brought up as a major obstacle to accession to the EU. We don't see it that way."

Stephany Griffith-Jones brought up the ratification process. "Henk Post categorically stated that enlargement is going ahead and the Commission, as well as the executive branches of all of the West European governments, has taken a clear stance. But what about the parliaments who still have to ratify this? We have just seen that while President Clinton was obviously committed to fast-track for NAFTA, the US Congress was not. So there may be serious problems in ratification. And also, even if it does pass through all of the parliaments, the conditions under which it may ultimately be offered may not be particularly favourable."

Henk Post suggested that substantial differences exist between President Clinton and the European Council. "The Council's position has been fully accepted, not only in 1993, but in all subsequent years and in all national parliaments. Enlargement as a policy is an accepted policy. It has not been ratified by all parliaments, but is has been accepted by all parliaments. The problem is not so much to have parliaments agree on enlargement, but to have them agree on the results of negotiations, the modalities of enlargement and the costs for themselves."

Institutional Capacity of Eastern Europe

Various participants raised questions about the institutional capacity of the CEECs. Frans van Loon, for instance, referred to widespread concern about the uncontrollability of portfolio flows and the fragility of banking systems in emerging markets. He wondered what type of policy the EU would develop. "I can imagine that the risks are rather substantial given the fact that the banking systems in a number of CEECs are still fragile and therefore pose major threats to stability." Zdeněk Drábek brought up the issue of state aid. "I agree with Mr. Post that the CEECs do not yet have the institutional capacity to implement market-type reforms, but how will the EU deal with this problem considering the examples of Crédit Lyonnais and Air France, private companies which have repeatedly asked for and have been granted various state subsidies?"

Henk Post responded by saying, "Cases like Crédit Lyonnais and Air France are exceptional cases as compared to the thousands of cases that we deal with each year that result, in almost every case, in very painful restructuring of the companies concerned. But also in both Crédit Lyonnais and Air France, dramatic restructuring is taking place upon the demand of the Commission. So I think that the EU is certainly capable of dealing with these problems. Furthermore, this view is shared by the governments of the candidate countries. Officials – and politicians – of the CEECs all share the perception that enormous restructuring must occur in their industries and enterprises, and they are relying on the Commission's assistance since this will make it easier to sell it to their own citizens.

There is no way that financing alone can take care of the needs that exist. We must help the candidate countries to enable private financing for public infrastructure works. The banking sector needs to be drastically reformed, and this will require shared management, shared experiences, benchmarking and a change in mentality. The same applies to the institution building that has to take place. As far as the risk of financial instability is concerned, this will take considerable effort, and we will find the candidate countries on our side, because it is also in their best interest to maintain a stable financial environment. This can be done in the manner I have just described by setting up programmes in which private organisations like banks and other institutions can participate to their own advantage and to the advantage of the candidate country."

Finally, Barry Herman questioned some data used in comparing CEEC output, labour and economies. "I want to take issue with some of the numbers. First András, in comparing the value of output in CEEC in the early and mid-1990s, you suggested that despite the fall in measured output, CEEC is not as small as it had seemed and that total output was more formidable. Then Hans Peter Lankes said that in the mid-1990s, markets were actually functioning, and this is an interesting statement because it means that in the early 1990s, markets were *not* actually functioning and prices did not have the same meaning. The result of these two comments is that we have GNP per capita figures for the early 1990s which have been calculated by adding up a bunch of prices which had no meaning and we converted them to dollars with an exchange rate that also had no meaning. In fact, we faced this issue at the UN in the early 1990s when we were trying to figure out how big their economies were and how to weight them in calculating aggregate growth rates. We found that the actual prices were not very indicative. So I don't think that the case is really made by saying they are less different than we thought they were by citing these earlier numbers.

Next, Hans Peter Lankes showed us a graph depicting labour, and the most striking thing is that in the early 1990s, the employment share in manufacturing or industry was very high compared to the benchmark. In the mid-1990s it looked more normal, partly because a lot of workers in the industrial sector became unemployed. But labour wasn't used in the same way in these economies as in the benchmark economies. And so again, I don't think the comparison is very meaningful. There has been some convergence in the sense that Eastern Europe now has Western European unemployment rates, but I don't think there is convergence in terms of the production structure of the economy.

I would say that to make the case, one should look at other things such as GDP calculated in purchasing power parity terms. Here Hungary is and has been the benchmark. It has been linked to Austria in the PPP exercises. The trends based on PPP and social indicators might give us some indication of actual possibilities of expenditure. It is a totally different kind of indicator, but when the economic numbers are not useful, sometimes the social indicators can be."

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Part III

Asia and Latin America

Preferential Trading and Asia

Arvind Panagariya[1]

I Introduction

For diametrically opposite reasons, both East Asia and South Asia remained virtually untouched by the first wave of preferential trade arrangements (PTAs) which engulfed much of Africa and Latin America during the 1960s and 1970s. Countries in East Asia found the key to their economic development in world markets. Countries in South Asia, on the other hand, concentrated on their domestic markets, and viewing the world markets (including regional markets) as a potential threat to domestic industrialisation, applied import-substitution strategies.

The Association of Southeast Asian Nations (ASEAN), founded at the First Summit of member nations in 1967 and often viewed as a preferential trading arrangement, in fact, began as a cultural organisation and grew out of security and strategic concerns.[2] The ASEAN Preferential Trading Area (APTA) was launched in 1977, but even APTA remained an essentially dormant organisation with preferential trade accounting for a minuscule portion of the member countries' trade. Despite a concerted effort at the Third Summit in 1987, member countries remained reluctant to offer meaningful trade preferences to each other.

There was no region-wide institution in South Asia until 1985 when the South Asian Association of Regional Cooperation (SAARC) was founded. Like ASEAN, SAARC also remained essentially devoid of any economic components during the first decade of its existence. While India had a long history of exchanging tariff preferences with other developing countries, they were insignificant.[3]

The regionalisation process in Asia was given a slight impetus during the late 1980s. Recognising the urgency of successful completion of the

1 The paper draws on my last several years of research on the subject. I thank Ajay Panagariya for assistance in preparing this paper.

2 The original membership of ASEAN included Brunei, Indonesia, Malaysia, Philippines, Singapore and Thailand. Vietnam joined the group in July 1995 and Burma, Cambodia and Laos in July 1997.

3 As Pursell (1996) reminds us, India had agreements dating back to 1967 with Egypt and Yugoslavia, an agreement inherited from pre-independence era with Myanmar, the 1976 Bangkok Agreement with Bangladesh, South Korea and Sri Lanka, another 1976 agreement with a group of 13 developing countries, a 1986 agreement with Mauritius, Seychelles and Tonga and a 1989 agreement with 24 developing countries.

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Uruguay Round, and fearful of the adverse impact on Asia of the rising tide of regionalism in the Americas and Europe, after consultation with Korean President Roh Tae-Woo, in January 1989 Australian Prime Minister R.J.L Hawk proposed the forum for Asia Pacific Economic Cooperation (APEC). APEC was intended to serve as an inter-governmental consultative body devoted to bringing the Uruguay Round to a successful conclusion and facilitating liberalisation of trade and investment policies at the regional level. An additional objective was promoting projects of common interest to member countries.[4]

In December 1990, Malaysian Prime Minister Mahathir Mohamed proposed the exclusively East Asian grouping called the East Asian Economic Group (EAEG). This proposal was vehemently opposed by the then US Secretary of State James Baker whose efforts at the ASEAN post-ministerial conference in July 1991 resulted in downgrading it to an East Asian Economic Caucus (EEAC). Baker also dissuaded Japan and Korea from joining the grouping. The EEAC has remained largely ineffective.

A somewhat more effective development was the supersession of ACTA by a framework agreement to form the ASEAN Free Trade Area (AFTA) at the Fourth ASEAN Summit in January 1992. According to this agreement, the member nations decided to establish a Free Trade Area (FTA) among themselves by 2007. The agreement requires that all quantitative restrictions on intra-regional trade be removed and all intra-union tariffs be reduced to 0-5% range. In 1994, the date of completion of AFTA was advanced to 2003.

In South Asia, under the aegis of SAARC, the new regionalism manifests itself in the creation of a South Asian Preferential Trade Area (SAPTA) with the eventual goal of creating a South Asian Free Trade Area (SAFTA). Though SAPTA was announced in 1993, there was no action on it until April 1995 when India announced some minor tariff concessions to Sri Lanka. This was followed by further minor concessions by India and Pakistan in November 1995.

This paper critically examines the desirability and likelihood of promoting preferential trade arrangements in Asia. I argue that the PTA route is neither desirable nor likely to be supported widely in Asia. Having benefited greatly from an open global trading system, East Asia as a whole has

4 APEC was launched in November 1989 at a ministerial meeting held in Canberra. Though Prime Minister Hawk had not consulted the United States prior to his January 1989 proposal, the latter quickly moved to ensure a seat for herself and its FTA partner Canada. The original membership of APEC consisted of twelve countries: Korea, six ASEAN members and five developed countries including the United States, Japan, Canada, Australia and New Zealand. In 1991, Korea negotiated the inclusion of China, Hong Kong and Taiwan while in 1993-1994, Mexico, Chile and Papua New Guinea were also admitted.

resisted, and will continue to resist, the promotion of discriminatory trade policies in that region.[5]

In assessing a regional arrangement, it has become customary to begin by examining the extent of intra-regional trade flows. This practice is the result of the so-called "Natural Trading Partners" hypothesis put forth by Wonnacott and Lutz (1989) and popularised by Krugman (1991, 1993) and Summers (1991). These authors argue that the greater the extent of trade among potential union members, the more likely that an FTA among them will be trade creating and, hence, welfare enhancing.

While I offer the interested reader the information on intra-regional trade flows in Tables 1 and 2 for East Asia and South Asia, respectively (at end of paper), it is important to note at the outset that the Natural Trading Partners hypothesis does not have a sound basis in economic theory. Recently, building on Bhagwati (1993) and Panagariya (1995, 1996), Bhagwati and Panagariya (1996) have systematically exposed the fallacy of this hypothesis.[6] We demonstrate, *inter alia*, that the extent of intra-regional trade has no definite relationship to the welfare effects of an FTA on the union as a whole. Intra-regional trade is an "average" concept whereas welfare effects are determined by what happens at the margin. A large intra-union trade simply means that there is less *scope* for trade diversion – it says nothing about the extent of *actual* trade diversion which is determined by responses at the margin. With this in mind, let me begin with the discussion of localised regional arrangements of AFTA and SAPTA and then consider the wider institution, APEC.[7]

II Evaluating AFTA and SAPTA

The most elementary argument against AFTA and SAPTA is that these regions are small in relation to the world market. In 1994, ASEAN members accounted for only 6% of world exports. If we exclude Singapore which has complete free trade and, hence, no scope for trade preferences, this share falls to 3.74%. The share of SAARC countries in the world mar-

5 This theme was developed in detail in Panagariya (1994, 1997a). The discussion on APEC later in the paper draws on Panagariya (1997b).

6 Also see Panagariya (1997) in this context.

7 I will not discuss the Australia-New Zealand Closer Economic Relations Trade Agreement (ANZCERTA) which came into existence in January 1983. Nor will I refer to other regional institutions, driven by academic or private-sector initiatives, such as Pacific Area Free Trade and Development (PAFTAD), Pacific Economic Cooperation Council (PECC) and Pacific Basin Economic Council (PBEC). An excellent summary of these institutions can be found in Ariff (1991, Chapter 5).

zFrom: *Regional Integration and Multilateral Cooperation in the Global Economy*
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kets is currently less than 1%. Thus, there is substantial scope for trade diversion within these regional arrangements.

At least in the case of AFTA countries, initial political-economy conditions are unfavourable to preferential trade liberalisation. The member countries have had highly disparate levels of trade restrictions. Singapore has long been a free-trading country while Malaysia has had generally low tariffs. By contrast, Indonesia and Thailand have had a history of high tariffs and the Philippines falls somewhere in-between. As I will demonstrate shortly, an FTA among countries with such disparate tariffs leads to a substantial income redistribution from high-tariff to low-tariff countries. Consequently, mobilising support for an FTA among them is an uphill task.

To make this point as concisely as possible, imagine the formation of an FTA between Singapore which has complete free trade and Indonesia which initially has relatively high tariffs.[8] This FTA consists of Indonesia offering a tariff preference to Singapore without a reciprocal preference from Singapore and will lead to a redistribution of income from Indonesia to Singapore. More surprisingly, the larger the quantity of imports into Indonesia from Singapore, the greater the income redistribution will be.

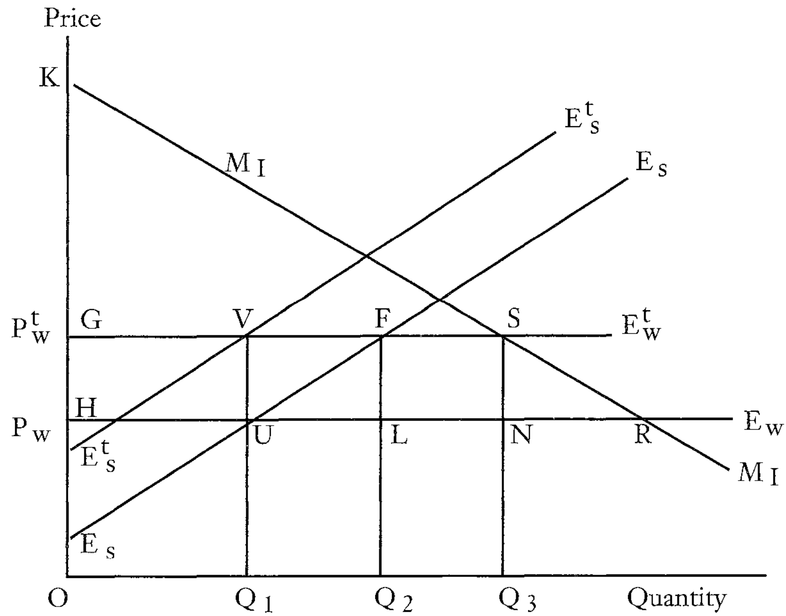
Thus, in Figure 1 (see next page), let us distinguish Indonesia by subscript I, Singapore by S and the rest of the world by W. Curve M_IM_I represents Indonesia's import demand for the product on which tariff preference is given, say, video-cassette recorders (VCRs). Curve E_SE_S represents Singapore's supply of exports of VCRs while P_WE_W represents the supply of VCRs from the world market. It is assumed that Indonesia and Singapore are small in relation to the world and take the world VCR price as given.

Initially, Indonesia levies a non-discriminatory tariff on imports equalling $P_WP^t_W$ per VCR so that export supply curves of Singapore and the rest of the world, as viewed by Indonesian consumers and producers, are represented by $E^t_SE^t_S$ and $P^t_WE^t_W$, respectively. The price of VCRs in Indonesia is P^t_W. The country imports OQ_1 from Indonesia and Q_1Q_3 from the rest of the world, collecting GSNH in tariff revenue. The consumers' surplus is given by triangle KSG.

Suppose now that, as a result of the FTA agreement, Indonesia eliminates the tariff on Singapore but maintains it for the rest of the world. This will shift the supply curve from Singapore down to E_SE_S. As long as any VCRs continue to come from the rest of the world, the price in Indonesia

8 The point was made originally in Panagariya (1995, 1996) and developed further in Bhagwati and Panagariya (1996). A general equilibrium treatment of the same problem is provided in Panagariya (1997c, 1997d).

Figure 1 An FTA between Singapore and Indonesia



will remain unchanged at P^t_W. Imports from Singapore will rise to $OQ_2$and those from the rest of the world will fall to Q_2Q_3. Indonesia will lose the rectangle GFLH while exporting firms in Singapore will be able to boost their profit by trapezium GFUH. Triangle FLU will be a deadweight loss due to trade diversion. As a result of the large redistribution effect, which is a rectangle, the loss to Indonesia in this example is much larger than the deadweight loss from trade diversion which is a triangle. And the larger the quantity of trade with Singapore, the larger the redistribution and the greater the loss.

Interestingly, if Indonesia chooses to remove the tariff on a non-discriminatory basis, no such loss occurs. In this case, the tariff is also removed on the rest of the world and the price of VCRs in Indonesia falls to the world level. The lost tariff revenue, which was transferred to Singaporean exporters under the FTA, is now transferred to Indonesian consumers. In addition, the country makes a net gain of triangle SNR from improved efficiency.

This analysis is perhaps at the heart of the developments with respect to preferential trading among ASEAN countries during the last two decades.

While unilateral liberalisation has made very substantial progress, preferential trading has proved to be an elusive goal. In 1987, a decade after APTA had been launched, preferences actually granted under it were minimal. Based on the 50% (or 35% if agreeable) ASEAN content requirement, there were 12,783 items on the PTA list. Out of these eligible items, only 337 items, or 2.6% of the total, were actually granted tariff preferences. Furthermore, only 19% of the total value of imports of these items enjoyed the preferential tariff.

At the Third Summit in 1987, the member countries adopted several changes aimed at strengthening tariff preferences. Systematic data on the progress resulting from these changes are unavailable, but from what is available, progress appears to have been less than sparkling. For example, the share of Indonesia's exports to ASEAN, which benefited from tariff preferences, rose from 1.4% in 1987 to 3.5% in 1989. Similarly, Indonesia's imports entering under preferential tariffs as a proportion of its total imports from other ASEAN countries rose from 1.2% in 1987 to 1.6% in 1989. Considering the fact that Indonesia's trade with the ASEAN 4 (ASEAN minus Singapore which has no preferences to offer and Brunei which is very small) was less than 3% during these years, these tariff preferences amount to virtually nothing.

In the past, to lengthen their lists, member countries have gone so far as to include snow ploughs among items to receive preferential tariffs. There are also instances of tariff preferences on zero-tariff goods. Even as late as July 1992, after AFTA had been signed, Indonesia announced a list 250 tariff cuts, but 90% of these were on different types of batik cloth only produced in Indonesia. The distributional conflict is well illustrated by a remark made by the former Indonesian foreign minister, Dr. M. Kusumaatmadja, at a 1992 meeting celebrating ASEAN's 25th anniversary.[9]

> "Singapore and Malaysia are always telling us to lower tariffs and duties and let their goods into the country. But in return, how about the free movement of labour? We will take your goods if you will take our surplus labour supply. When they hear this and think about all those Indonesians coming to work in their countries, then they say, 'wait a minute, maybe it's not such a good idea'."

It may appear that the September 1994 meeting of ASEAN Economic

9 Financial Times, January 26, 1993.

10 Accordingly, all tariffs on intra-regional trade are to come down to 5% or less by the year 2003. To qualify for these low tariff rates, a product must satisfy a content requirement according to which 40% or more of the product's value added must originate within the region.

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Ministers, which advanced the target date for the conclusion of AFTA from 2007 to 2003, made a break from this past trend.[10] Yet, available information indicates that all significant liberalisations in the region have taken the non-discriminatory form. Of particular importance are trade liberalisations in Indonesia during 1995 and 1996. Despite the fact that these liberalisations were partially undertaken to satisfy AFTA requirements, they were non-discriminatory. It remains to be seen, however, whether this non-discriminatory approach will survive as we approach the 2003 deadline and tariffs on even sensitive products must be reduced to 5% or less.

The case for preferential trading among SAARC countries, especially when compared to the alternative of unilateral liberalisation, is also weak. Though the direction of tariff-redistribution effects in this case is difficult to assess since all member countries currently have high tariffs, the likelihood of trade diversion in this regional arrangement is extremely high. As noted above, the region supplies less than 1% of the world exports.

A case for SAPTA or SAFTA has also been made on political grounds. It is argued that the countries in South Asia have been traditionally hostile to one another. This hostility has manifested itself, for instance, in Pakistan's refusal to grant India Most Favoured Nation (MFN) status even though both countries are among the original 23 signatories to the General Agreement on Tariffs and Trade (GATT). According to this argument, SAPTA may help contain hostility among countries of the region by expanding intra-regional trade. I am sceptical of the argument. There are perhaps better targeted instruments to achieve harmony than tariff discrimination. Moreover, if the countries in the region continue on the current path of non-discriminatory liberalisation and trade on an MFN basis, intra-regional trade among them will grow anyway without the fear of trade diversion.

In part, the political argument is based on the mistaken impression that preferential trading among ASEAN members promoted peace and harmony among its members. As I have already documented, preferential trading has played a minimal role in ASEAN. In fact, during the period preceding the formation of ASEAN, attempts at preferential trading had led to discord and a disruption of peace in the region. Thus, in 1959, Singapore won the freedom for internal self rule from the British and the People's Action Party (PAP), led by Lee Kwan-Yew, came to power. Under the British, Singapore had already accumulated a long history of non-discriminatory free trade.[11] In its election manifesto, PAP had called for the establishment of a common market with the Federation of Malay to obtain free access to

11 In 1867, under Straits Settlement, Singapore became a Crown Colony and was given the free-port status.

the latter's market. Therefore, when Tunku Abdul Rahman, Prime Minister of Malayan Federation, proposed the formation of a Federation of Malaysia comprising his own nation, Sarawak, British North Borneo and Brunei, Lee Kwan-Yew supported it and prevailed. In September 1963, Singapore became a part of the Federation of Malaysia. The merger proved a mistake for Singapore, however. Indonesia, its second largest trading partner, refused to recognise the Federation of Malaysia and adopted a policy of confrontation. Singapore's entrepôt trade suffered a serious setback and, for the first time since the Second World War, the country experienced negative growth of -4.3% (Ow,1986). This was a case of regional integration which led to more, not less, hostility.[12]

III An APEC Free Trade Agreement?

During its first two or three years, APEC was a low-profile organisation. Because of its diverse membership, member countries proceeded cautiously, aiming to develop closer ties through consultation, cooperation and consensus rather than formal negotiations. Indeed, during its first four years, APEC operated without a formal secretariat. This has changed, and today APEC has become the central focus of trade relations among member countries. Some preferential-trading enthusiasts would like to see APEC turned into yet another FTA.

As Barfield (1996) correctly points out, "it was the Clinton administration that moved to change the focus of APEC from an informal consultative mechanism to a more formal organisation promoting trade liberalisation – and ultimately preferential trade arrangements – within the Pacific region." Perhaps to pressure the European Community into yielding to the additional concessions the United States was seeking at the Uruguay Round negotiations, the Clinton administration proceeded to upgrade the 1993 annual meeting of APEC ministers in Seattle to a meeting of the heads of state and signalled its intention to promote free trade in the Asia-Pacific region through APEC.

The impetus provided by Clinton at the Seattle meeting in November 1993 culminated the following year in the Bogor declaration. Led by President Suharto of Indonesia, APEC members agreed to establish free trade by the year 2010 in the developed member countries and by 2020 in the developing member countries. Though the meaning of 'free trade' in this context has remained unclear and no strategy for achieving the goal

12 By August 1965, Singapore had separated from the Federation and established itself as a separate country.

has been articulated, the agreement has permanently changed the dynamics of APEC, turning it into a high-profile body aiming to promote a more liberal trade and investment regime among its members.

How can and should APEC proceed to attain its new goal of free trade by 2010/2020? The APEC members agree that any liberalisation that takes place should be GATT-consistent. Indeed, given the recent tightening of multilateral rules under the Uruguay Round, it is difficult to imagine that any significant liberalisation can be pursued in a manner that is not consistent with GATT. Short of initiating another round of multilateral negotiations, this fact narrows down APEC's options to four modes of liberalisation: one-way trade preferences by developed to developing member countries under the Generalised System of Preferences (GSP), reciprocal trade preferences between developing member countries under the Enabling Clause of GATT, FTAs and customs unions under GATT Article XXIV, and unilateral liberalisation on the MFN basis.

Of these four modes, the first two are unlikely to play any significant role in the APEC framework. Developed country members are not likely to offer trade preferences on a non-reciprocal basis. Nor are developing member countries in East Asia keen to trade preferences with each other on a discriminatory basis. As already discussed, AFTA falls under this category but the exchange of trade preferences based on it has been minimal. Instead, the member countries have chosen to lower trade barriers on a non-discriminatory basis.

This leaves an APEC FTA and non-discriminatory reductions in trade barriers as the possible options. Both of these approaches are characterised by tension between the United States and Asian members of APEC. The tension in non-discriminatory approach comes from the fact that the United States is entirely disinterested in offering reductions in trade barriers without reciprocity. The US opposes the approach on the ground that it gives EU additional access to the US market without offering any reciprocal liberalisation. At the APEC ministerial conference in Osaka in 1995, Mickey Kantor, the US Trade Representative at the time and now the Commerce Secretary, insisted that future trade liberalisation will allow "no free riders." (Barfield, 1996).

Therefore, if trade liberalisation within the APEC framework is intended to incorporate all members without violating GATT, the logical outcome is an APEC FTA or customs union. Though the US Administration has not explicitly advocated such a bloc, it is the only possible implication of the demand for reciprocity with GATT consistency. And an FTA does sit well with Clinton Administration's new-found wisdom on trade policy which has elevated PTAs to essentially the same status as multilateral liberalisation. Thus, the 1995 President's Report (pp. 214-215) notes,[13] "Possibly the most distinctive legacy of this Administration in international trade is the foundation it has laid for the development of open, overlapping plurilateral trade agreements as stepping stones to global free trade. The Administration's plurilateral initiatives in North America, the rest of the Western Hemisphere, and Asia embody principles of openness and inclusion consistent with GATT. They will serve as vehicles for improving access to foreign markets..."

The Asian members countries do not share the US enthusiasm for either reciprocity or "negotiated liberalisation." Instead, they have shown a clear preference for adherence to the MFN principle. At Osaka, the Asian view of "concerted unilateralism" prevailed with each member being offered the opportunity to voluntarily adopt its separate path to liberalisation. In pursuit of the Bogor goal of free trade by 2010 or 2020, the member countries were asked to first provide a "downpayment" for free trade at the next annual meeting in the Philippines in December 1996. The result was the adoption of the so-called "individual action plans" by member countries at the Philippines summit. These plans offered little additional liberalisation beyond the countries' unilateral trade-reform programmes. Likewise, the 1997 summit in Vancouver, Canada did not produce any substantive results in terms of trade liberalisation.

For the foreseeable future, Asian members of APEC have successfully countered the US insistence on reciprocity. As an aside, it may be noted that the members of the Eminent Person's Group, headed by Fred Bergsten of the United States, which had pushed for converting APEC into an FTA have been allowed to disband at the expiration of their term rather than continuing for another term.

We may ask the model for future regional arrangements, especially major arrangements such as the Free Trade Area of the Americas and the Trans-Atlantic Free Trade Area. Indeed, a good case can be made for this approach. If regionalism is here to stay, the APEC model has some clear advantages. Most importantly, it does not intend to be a PTA and, as such, is not accompanied by trade diversion and the "spaghetti bowl" of tariffs which is being created by PTAs in Europe and Latin America. APEC's commitment to the Most Favoured Nation principle ensures that countries do not lower tariffs merely to exclude non-members from their markets. APEC has also been more forthcoming in adding new members on equal footing.[14] If adopted by the planned Free Trade Area of the Americas and

13 I may also note in passing that in early 1994, the Administration had also discussed the possibility of extending NAFTA to Korea. See Saxonhouse (1996) for details.

14 In this context, the decision by member countries at the Vancouver summit to place a 10-year moratorium on new entrants is unfortunate and inconsistent with APEC's goal to be open.

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the Trans-Atlantic Free Trade Area, these characteristics will go a long way towards preserving the integrity of the global trading system.

IV Concluding Remarks

It is a folly to push for PTAs in general and in Asia in particular. In addition to the possibility that PTAs can slow down progress on the multilateral front, there are at least four reasons which justify skepticism towards PTAs as an instrument of trade liberalisation. First, since they are discriminatory in nature, they can and do lead to trade diversion. Because weaker, uncompetitive industries are often the ones that succeed in lobbying against foreign competition, PTAs are often voted in when trade diversion is the dominant force. This is a point made forcefully in the recent theoretical work by Grossman and Helpman (1995) and Krishna (1995). Similarly, the careful empirical work of Kowalczyk and Davis (1996) shows that in NAFTA, the sectors which were allowed the longest phase-out periods for implementing the accord in the United States were the ones where the US lobbies were most powerful. Most importantly, the recent World Bank study by Yeats provides systematic evidence of wholesale trade diversion in the Southern Cone Common Market popularly known by its Spanish acronym Mercosur. Thus, the "natural trading partners" hypothesis has been shown to have no foundation in theory by Bhagwati and Panagariya (1996) and in reality (Yeats, 1996).

The second problem with PTAs is that they can lead to increased protection against outside countries. In bad times, pressures for protection grow and when a PTA member is unable to raise trade barriers against a partner, the burden of increased trade barriers falls disproportionately on the outside countries. Such increases in trade barriers can turn even an initial trade creation into trade diversion.[15] This is not idle speculation. External tariffs in Israel went up after it concluded FTAs with both the EU and the United States.[16] Similarly, in the aftermath of the Peso crisis, Mexico raised tariffs on outside countries on 503 items from less than 20% to 35%. Another way of transferring the burden to outside countries is through increased anti-dumping and safeguard actions against outside countries.

Third, the rules of origin in FTAs have been creating a spaghetti bowl. This problem is bound to be compounded as overlapping FTAs proliferate. As an example, NAFTA's rules of origin are already complicated, but

15 This point was made forcefully by Bhagwati (1993).
16 For details, see Halevi and Kleiman (1994).

suppose that Chile, who already has an FTA with Mercosur, joins NAFTA. Since Mercosur does not have an FTA with NAFTA, the rules of origin for Chile's entry into NAFTA are likely to be more complicated than those for NAFTA. The rules of origin will open a further avenue for trade diversion. Thus, a manufacturer in Chile will have to make a decision on whether to buy his components in the Southern Cone or North America depending on whether he wants to sell the final product in Mercosur or NAFTA. If he relies on a single source of supply, he will be able to satisfy the rules of origin for only one of the two destinations. Moreover, if the most efficient supplier happens to be in Asia, trade diversion will be inevitable.

Finally, measures which are WTO inconsistent have begun to sneak back into PTAs. One such example is the trade-balancing requirement within Mercosur. The WTO has just outlawed this Trade-Related Investment Measure or TRIM. Yet it has been introduced by the members of Mercosur on firms operating within the union. Thus, an Argentine company operating in Brazil must export as much Brazilian goods to Argentina as it imports from the latter. Similarly, though voluntary export restraints (VERs) have been outlawed by the Uruguay Round Agreement, VERs were resurrected on tomato imports into the United States from Mexico within the context of NAFTA. We do not currently have evidence of the extent of such WTO-inconsistent measures, but they certainly have the potential to subvert the multilateral process down the road.

Given the history of adherence to the MFN in Asia and the reliance on world markets rather than regional markets for growth and cultural and political diversity, the promotion of preferential trade makes even less sense than elsewhere in the world. Indeed, the best policy for APEC is to bring its 2010/2020 agenda to the World Trade Organization and press for a comprehensive round which will promote free trade in textiles and clothing (which interest developing Asian countries) and not merely in products such as information technology (which interest the United States and the European Union).

Table 1 East Asian Exports
(in millions of dollars)

	ASEAN			Northeast Asia (excl. Japan)			Japan			World		
	1984	1989	1994	1984	1989	1994	1984	1989	1994	1984	1989	1994
Indonesia	2,490	2,431	5,302	1,187	2,538	7,098	10,353	9,252	11,711	21,881	21,941	37,958
Malaysia	4,306	6,314	15,870	1,606	3,071	8,048	3,770	4,016	7,010	16,563	25,049	58,748
Phillipines	516	542	1,626	484	722	1,550	1,034	1,581	2,020	5,343	7,754	13,433
Singapore	7,125	10,276	27,489	2,502	6,233	16,907	2,255	3,828	6,766	24,070	44,769	96,419
Thailand	1,053	2,290	5,832	690	2,026	4,647	965	3,422	7,524	7,414	20,175	41,757
Vietnam	55	120	606	80	108	610	47	261	1,227	250	1,936	4,706
ASEAN	**15,548**	**21,973**	**56,725**	**6,549**	**14,698**	**38,868**	**18,424**	**22,360**	**36,258**	**75,521**	**121,624**	**253,021**
China	1,960	3,008	6,710	6,586	21,916	38,983	5,155	8,395	21,490	24,824	52,916	120,822
Hong Kong	2,361	4,947	9,974	6,353	23,416	55,772	1,251	4,525	8,436	28,314	73,113	151,393
Korea	1,402	3,814	12,418	1,540	4,635	16,950	4,610	13,167	13,523	29,259	60,496	96,040
Taiwan	2,163	6,418	13,202	2,557	7,930	29,769	3,197	8,913	10,719	30,435	65,573	93,672
Northeast Asia (excl. Japan)	**7,886**	**18,187**	**42,304**	**17,036**	**57,897**	**141,474**	**14,213**	**35,000**	**54,168**	**112,832**	**252,098**	**461,927**
Japan	14,149	25,943	60,880	26,932	51,789	92,581	–	–	–	169,748	274,590	395,201
World	**66,952**	**114,805**	**253,764**	**93,561**	**220,153**	**433,823**	**115,672**	**185,666**	**254,230**	**1,790,300**	**2,963,100**	**4,184,000**

Source: IMF, *Direction of Trade and Statistics* (various issues). Taken from Soesastro (1996).

Table 2 South Asian Trade
(in millions of dollars and percentages)

Country	Year	Exports to			Imports from		
		SAARC	World	SAARC as % World	SAARC	World	SAARC as % World
Bangladesh	1986	54	889	6.1	91	2,550	3.6
	1993	55	2,277	2.4	477	4,015	11.9
India	1986	277	9,135	3.0	73	15,051	0.5
	1993	763	19,964	3.8	95	22,493	0.4
Maldives	1986	5	25	20.0	9	78	11.5
	1993	12	66	18.2	24	218	11.0
Nepal	1986	51	134	38.0	102	314	32.5
	1993	43	389	11.0	96	545	17.6
Pakistan	1986	109	3,383	3.2	95	5,367	1.8
	1993	216	6,701	3.2	147	9,492	1.5
Sri Lanka	1986	58	1,163	5.0	144	1,829	7.9
	1993	86	2,846	3.0	363	4,311	8.4

Source: Bhuyan (1996).

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Regional Integration in South Asia

Miria Pigato[1]

I Introduction

I am going to discuss two issues. The first is the rise of regionalism in South Asia and its specific characteristics. The second issue concerns the potential benefits that South Asian countries would derive from a regional trade agreement. I will conclude by explaining why we, at the World Bank, still believe that regional integration in South Asia is desirable in spite of apparently modest economic benefits.

II The Rise of Regionalism in South Asia

The rise of regionalism in South Asia is quite recent. The South Asian Association for Regional Cooperation (SAARC), which includes India, Pakistan, Nepal, Bangladesh, Bhutan, Sri Lanka and the Maldives, was created in 1985. But very little happened until 1993 when there was a major initiative to promote a South Asian Preferential Trade Arrangement (SAPTA). This arrangement became operational in 1995. The first round of negotiations led to a few tariff concessions, discussed on a product-by-product basis, and achieved only after endless discussions among the states. Only 6% of traded goods was involved. In 1996, however, a stronger determination to regional integration led the countries to undertake a second round of negotiations, which included more extensive trade concessions and a commitment to establish a free trade area by 2000 or 2005 at the latest.

Why did South Asia take such a long time to move to regionalism? Before 1947, the region was characterised by intense trade and the countries were integrated – even from a monetary point of view. But after independence, trade essentially disappeared. Currently, intra-regional trade accounts for only 4-5% of total trade in the region, compared to 40% in East Asia, 43% in NAFTA and even 12% in Sub-Saharan Africa.

Why did trade disappear? First, it disappeared as a result of political and

1 The opinions expressed here are those of the author and do not necessarily represent those of the World Bank.

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military turmoil. There have been three wars between India and Pakistan. During the last war in the early 1970s, Bangladesh emerged as an independent nation. But border confrontations have continued to shadow the political dialogue between India and Pakistan. Second, up to 1991, all of the countries in the region adopted protectionist policies. Before 1991, the nominal average tariff rate in India was 125% and the highest was 335%. Furthermore, most imports were protected by quantitative restrictions. Despite much progress in deregulation and trade liberalisation in recent years, nominal protection rates are still around 20-25% – much higher than in developing regions where the average is 15%. South Asia remains one of the most protected and least integrated regions in the world.

In addition to trade protection, transit barriers still exist. India has denied transit facilities to Nepal and Bhutan for export to Bangladesh. And Bangladesh has denied India transit through its territory to reach the northern Indian states. Of course, illegal trade has flourished. Our estimates indicate that the volume of *illegal* imports from India to Bangladesh is basically the same as the volume of *legal* imports.

We see the movement toward regionalism as a very positive phenomenon. First of all, it is an initiative that comes from new governments and new leaders, at least in Bangladesh, India and recently Pakistan. These new leaders claim that they want more cooperation and peace in the region. And in fact, this year, we have witnessed the signing of a water agreement between India and Bangladesh ending a historical dispute over the Ganges; another agreement between India and Nepal on the Mahakali River; and the signing of the India-Nepal trade treaty giving preferential access to Nepal's exports into the Indian market.

In this context, SAARC has really represented a forum for coordinating policies of liberalisation. Regionalism in South Asia does therefore not represent a withdrawal from the international economy in order to create a protected region or market. On the contrary, it is part of a strategy that all of the countries in the region have undertaken to open up and become outward oriented.

III The Benefits from a Regional Arrangement

Would the region gain from promoting a free trade area? A number of studies have examined this issue. Srinivasan, for example, using a gravity model, found that only the smaller countries would derive substantial benefits from a free trade agreement with their neighbours. By contrast, the larger countries, India and Pakistan, would gain more by liberalising their trade in a non-discriminatory way. In our own calculations, using a general equilibrium model of the world economy, we arrive at basically the same conclusion. Our results suggest that India's welfare gains are much larger in the non-preferential liberalisation hypothesis. This is derived from the fact that trade creation would not be significant since the rest of South Asia is much smaller than India. Moreover, terms of trade gains would also be small for India because protection in the rest of South Asia is lower than in India. It is important to note that the model is based on 1992 tariff data, and I suspect that if we were to conduct the analysis with 1997 data, we would find that the gains for India would be even smaller. In contrast, the benefits the rest of South Asia would derive from a preferential trade arrangement would be larger than those from non-discriminatory liberalisation – the smaller countries would indeed obtain significant terms of trade gains from open access to the highly protected Indiana market.

While our calculations indicate that the welfare benefits of a regional trade agreement would be limited, we believe that political and social considerations justify a positive assessment of regional integration. First, we believe that an intensification of the process of regionalisation would increase the chances for settling border disputes and would encourage cooperation. A by-product of a more peaceful environment would be a reduction of military spending. This would be a major achievement, as military spending represents such a large share of public revenue (37% in Pakistan). A common market would also help attract foreign direct investment and multinational enterprises, particularly in the textile and garment industries, thus accelerating industrial restructuring in these sectors. Finally, regional integration would also lend support to India's quest for becoming a member of APEC. Given its philosophy of open regionalism, APEC ought to be more interested in an India that is practising a good neighbour policy than in an India that is persisting with the style of policies from the past.

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Towards an Evaluation of Regional Integration in Latin America in the 1990s

Robert Devlin and Ricardo Ffrench-Davis[1]

I Introduction

The decade of the 1990s has witnessed a wave of regional integration initiatives in Latin America: more than 14 agreements – free trade areas or customs unions – since 1990 with a handful more in varying degrees of negotiation (see Table 1 at end of paper). However, this was not just a Latin American phenomenon as regionalism has more than ever become a global trend (Mistry, 1996). Indeed, now Japan, South Korea and Hong Kong are the only World Trade Organization (WTO) members which are not signatories of at least one preferential trade agreement (WTO, 1995).[2]

Regional integration is not new to Latin America. Economic integration played an important role in the region's early post-war economic history. The 1960s and 1970s saw a number of very ambitious initiatives inspired by the successful Western European experience (Ffrench-Davis, Muot new to Latin America. Economic integration played an important role in the region's early post-war economic history. The 1960s and 1970s saw a number of very ambitious initiatives inspired by the successful Western European expey set in by the late 1970s and the discussion of regional integration was all but silenced by the external debt crisis of the early 1980s.

The renaissance of regional integration has not been uncontroversial. Some, including the authors, view regional integration as a potentially valuable tool for modernisation and development in a second-best world. Others, however, interpret regional integration as an inferior, costly policy option, which is harmful to the countries involved, and the multilateral system more generally. The purpose of this article is to review the strategic dimensions and rationale of regional integration, place potential costs and benefits in their proper perspective and outline directions for future

1 We thank F. Ballestero, A. Jessen and A. Panagariya for their helpful comments and Brenda Simonen and Francois Dionne for their statistical assistance. The opinions expressed here are those of the authors and do no necessarily reflect those of their respective institutions (IDB and ECLAC).

2 Of course Hong Kong has just been transferred to China, which has yet to become a member of the WTO.

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research and economic policy. Section I is a brief review of trends in intra- and extra-regional trade and some of the factors driving it. This is followed by a discussion, in Section II, which places regional integration in the broader Latin American policy context that is conditioning its effects. Section III outlines what countries expect to achieve from regional integration and the costs that can be confronted. Section IV attempts to put the costs and benefits into perspective and offers directions that might help us better evaluate the full effects of integration and thereby soften some of the rougher edges of the policy debate. Section V concludes with policy suggestions that should contribute to amplifying the benefits and minimising the costs for the participants in regional integration agreements and the world community at large.

II The Growth in Trade[3]

The 1990s have witnessed a rebound in the region's trade after the crisis of the previous decade. Between 1990 and 1996, the region's exports expanded by 76%; imports grew even faster, at 127%. Imports as a percentage of the region's GDP now equals 18%, up from 10% in 1990[4] (Figure 1). Moreover, the region's growth of imports has consistently exceeded that recorded at the world level: according to WTO estimates, the value of world imports grew by an average 7% a year between 1990 and 1996, compared to 15% for Latin America.

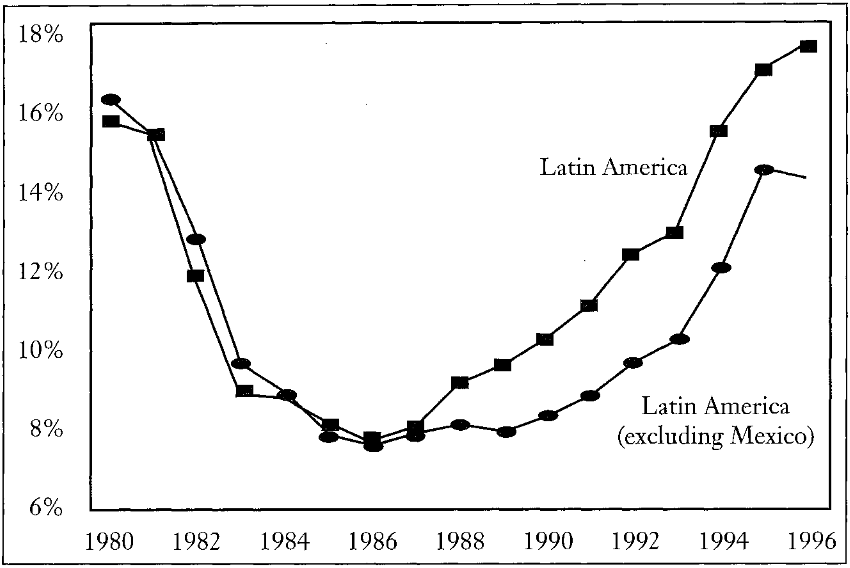
A closer look at the region's trade performance in the 1990s reveals the following trends:

- Intra-regional trade has grown more rapidly than trade with countries outside the region. This trend is particularly pronounced in the case of *exports* (Table 2). Since 1990, the value of intra-regional exports has grown by 18% a year on average, compared to 9% for extra-regional exports. Intra-regional exports now account for 18% of total Latin American and Caribbean exports, up from 12% in 1990. Without Mexico, the figure reaches 27%, from 15% at the beginning of the decade.
- It is interesting to compare real (constant prices) changes in exports to GDP growth. Overall, the GDP of the region grew 20% between 1990 and 1996. The quantum of total exports rose 59%, thus increasing by one-third the export ratio of Latin America. The leading destinations by

3 For a more detailed overview of intra-regional and extra-regional trade, see ECLAC (1997) and IDB (1997).

4 When Mexico is excluded, the figures are 14% and 8% respectively.

Figure 1 Latin America Imports as a percent of GDP



Source: IDB, Department of Integration and Regional Programs, Division of Integration, Trade and Hemispheric Issues, ESDB database.

far were intra-regional markets, which expanded 160%. However, extra-regional exports also increased much faster than GDP, more than doubling the latter's rate of growth.

- Growth rates for intra- and extra-regional *imports* have been more homogeneous (Table 3). While intra-regional imports expanded by an average of 18% a year between 1990 and 1996, extra-regional imports also grew very fast, by 14% a year, reflecting a generalised import boom in the region. This, coupled with the aforementioned important growth of extra-regional exports, confirms that regional integration has been consistent with open regionalism.

The marked difference in the growth rates of the region's overall exports and imports (76% and 127%, respectively) reflects a large imbalance in the growth of trade with *extra-regional markets*, with imports from these sources expanding nearly twice as fast as exports to extra-regional destinations. For the trends in direction of trade, see Figures 2a and 2b.

Some factors influencing current trends are:

Geography. Areas dense in capital and population often tend to naturally

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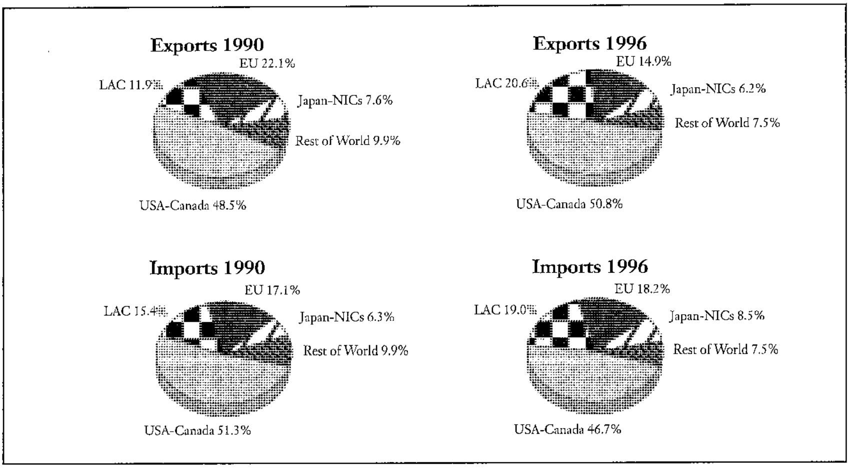
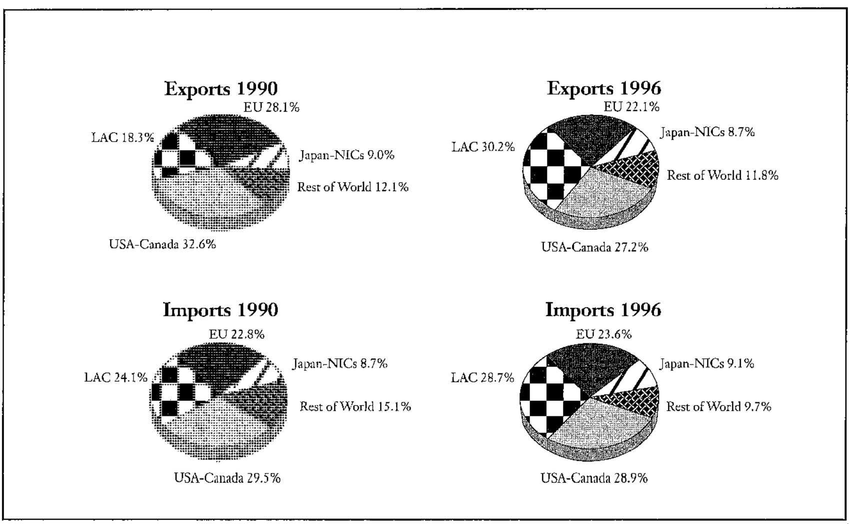
Figure 2a Latin America and the Caribbean – Direction of Trade



Note: Includes Mexico maquila trade. LAC is Latin America and the Caribbean. NICs includes Hong Kong, Korea, Singapore and Taiwan.
Source: IDB, Department of Integration and Regional Programs, Division of Integration, Trade and Hemispheric Issues.

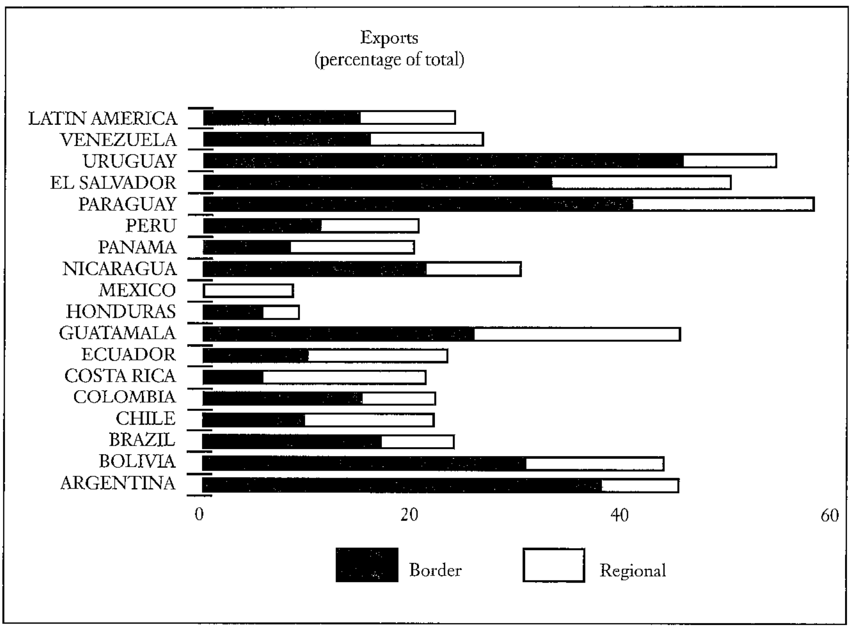
Figure 2b LAC excluding Mexico – Direction of Trade



Note: LAC is Latin America and the Caribbean. NICs includes Hong Kong, Korea, Singapore and Taiwan.
Source: IDB, Department of Integration and Regional Programs, Division of Integration, Trade and Hemispheric Issues, based on DATAINTAL.

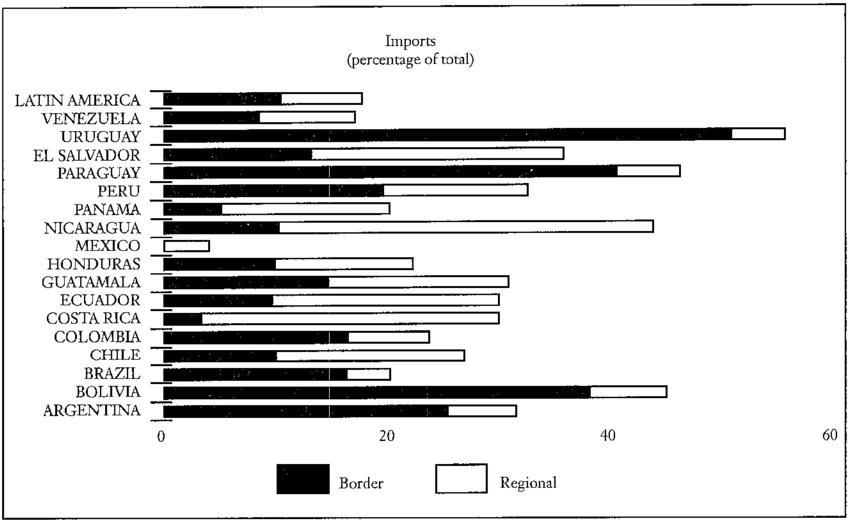
interact and trade relatively more intensively with increasing specialisation (Ballestero, 1996). Among the economic factors behind this are the positive externalities of location and agglomeration. The tendency can be further enhanced when income levels, cultures, tastes and languages are similar, as they are in Latin America, and when differentials exist in transport costs between contiguous and non-contiguous countries. On these criteria, large natural geographic areas of economic integration would appear to exist in Latin America in its Southern Cone, Venezuela-Colombia-Ecuador, Central America and North America for Mexico. In fact, the boom in intra-regional trade has largely been among neighbouring countries in the region (Figures 3a and 3b).

Figure 3a Intra-Regional and Border Exports, 1994



Note: The countries included are those that share borders and have available information. Mexican border trade does not include trade with the United States.
Source: IDB, Department of Integration and Regional Programs, Division of Integration, Trade and Hemispheric Issues.

Figure 3b Intra-Regional and Border Imports, 1994



Note: The countries included are those that share borders and have available information. Mexican border trade does not include trade with the United States.
Source: IDB, Department of Integration and Regional Programs, Division of Integration, Trade and Hemispheric Issues.

Relaxation of the External Restriction. The decline of world interest rates, debt relief and a return of external capital flows in the 1990s (Devlin, Ffrench-Davis and Griffith-Jones, 1995) have dramatically increased import capacity in the region with consequent reactivation of economic activity. Since intra-regional imports equal intra-regional exports, the generalised import boom has been reflected in the marked growth of intra-regional exports.

Real Exchange Rate Appreciation. The region's external trade performance has also been influenced by the exchange rate behaviour of Latin American and Caribbean countries. The simultaneous liberalisation of the capital account in many countries, coupled with a surge in supply of foreign capital and the use of exchange rate anchors in support of stabilisation programmes, contributed to real currency appreciations in an important number of countries (just when the opposite, a real depreciation, was need-

5 Some countries like Colombia and Chile have actively tried to slow down pressures for real appreciation by avoid anchors and resorting to, among other things, foreign exchange regulations and imaginative financial engineering (Devlin, Ffrench-Davis and Griffith-Jones, 1995).

ed to facilitate export-led growth). An exchange rate index, weighted by GDP, gives an average revaluation of 25% between late 1980s and 1994. This situation has tended to encourage imports while, at the same time, discouraging the region's exports.[5] Moreover, since real appreciation of exchange rates with respect to the rest of the world has been simultaneous among a significant number of neighbouring countries in Latin America in the 1990s, the dampening effects on exports have been relatively stronger in the extra-regional market.

Economic Reforms. The structural reforms undertaken in the late 1980s and 1990s have energised private market activity, facilitated the emergence of new investors and trade. Unilateral trade liberalisation in particular has been a key in exposing natural market opportunities for exports to neighbouring countries that heretofore were hidden behind the wall of national protection (IDB, 1996a).

Sub-Regional Trade Agreements. The aforementioned explosion of sub-regional and bilateral trade agreements in the 1990s has stimulated intra-regional trade through many mutually reinforcing effects; for example:

There has been an increased flow of information and public attention on opportunities in an adjacent market ("agreement-led" growth in trade).

Trade preferences are an integral part of the regional integration agreements and provide incentives for intra-regional trade. The absolute level of the preference over time will depend on the evolution of external tariff rates. Nevertheless, it is important to point out that many of the preferences of the older trade agreements in the region have been progressively eroded by the unilateral liberalisation of trade in the late 1980s and early 1990s.

In contrast to unilateral opening, the free trade arrangements have given the private sector reciprocal and legally binding market access which has reduced the risks of trade and investment barriers emerging in the affected market. This in turn increases private sector confidence. An example of the especially strong nature of a reciprocal commitment is Mexico, which during the peso crisis exempted NAFTA partners from a temporary increase of tariffs on 500 items (5% of total tariff lines).

A preferential agreement can signal the continuing commitment of public authorities to trade liberalisation, during a conjuncture in which unilateral or multilateral liberalisation is not possible or desirable. In agreements such as Mercosur, sub-regional trade liberalisation is accompanied by an additional commitment involving a much broader political message, pursued at the highest official levels, to promote deep economic integration and political cooperation among member countries.

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III The New Face of Regional Integration in Latin America and the Caribbean

Regional integration must be evaluated in the broader context of the overall contemporary economic policy which is conditioning its effects. The regional integration initiatives immediately following the Second World War inserted themselves into the prevailing development strategy of import substitution. Indeed, the integration schemes of that period were designed in part to enhance the efficiency of the import-substitution model through a strategic expansion of the highly protected national market.[6] While the integration initiatives achieved some important results – for example, the significant liberalisation of reciprocal trade in Central America – outcomes fell far short of objectives. On the one hand, the strong national political commitments to domestic protection made opening up even among associate countries an extremely labourious negotiating process that rarely achieved more than very partial results. On the other, the costs of trade diversion were amplified due to the general presence of high average tariffs on third parties and extensive use of non-tariff restrictions.

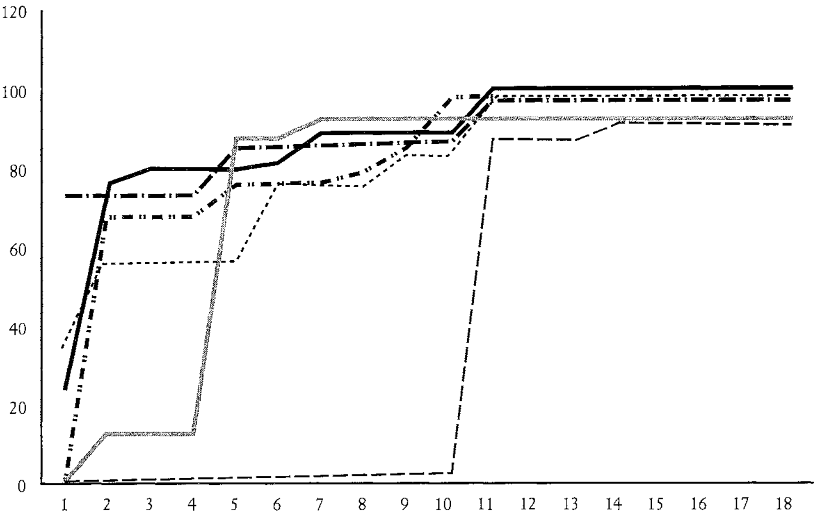
The traditional model of development in Latin America changed in the 1980s and this, in turn, has dramatically changed the face of regional integration itself. In effect, the regional integration of today has inserted itself into the broader overall strategy of opening up to the world economy. Countries have entered into multiple arrangements that are eliminating tariffs among partners across substantially all trade within a relatively short period of time, and which often involve other commitments that even go beyond the WTO's trade-related disciplines. In any event, Figure 4 and Table 4 respectively show, for a sample of regional agreements in Latin America, that the reciprocal liberalisation process is typically completed for the bulk of trade within a period of 10 years and negotiated exceptions have rarely exceeded 6% of total tariff lines.

In the initial stages of their development, regional integration arrangements link up with the overall economic reform process most obviously through its trade liberalisation component. In effect, regional integration is a third tier of a three-tier liberalisation process.

(i) Unilateral Liberalisation. The first and most dramatic level of liberalisation has been through unilateral measures to open up economies.

6 In some cases, as in the Andean Pact, there was the deliberate effort to drastically reduce the level and dispersion of effective tariffs.

Figure 4 Selected FTAs in Latin America. Years to liberalisation
(percentage of tariff items liberalised)

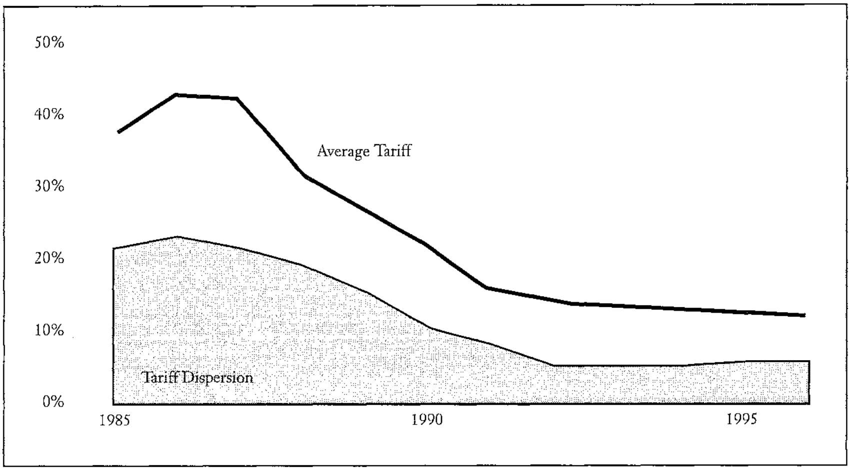


Source: Estevadeordal (1998).

Profound trade reforms have been undertaken in Latin America as part of a broad-ranging process of change, in which international competitiveness and exports play a leading role. Most countries are in search of export-led development. Nonetheless, in contrast with the experience of East Asian nations, the main instrument of trade reform has been a relatively indiscriminate and rapid liberalisation of imports (Agosin and Ffrench-Davis, 1995; ECLAC, 1995). The aim is to expose producers of importables, which had often been receiving a high level of protection, to outside competition, while also encouraging the output of exportables. It is expected that this will result in higher productivity, the absorption of new technologies and increased specialisation.

Most of the countries' trade reforms could be described as sudden and drastic. The experience is reflected in the fact that the average tariff in Latin America and the Caribbean has declined from 45% in the second half of the 1980s to 13% in 1995, accompanied by a sharp reduction of tariff dispersion as well (Figure 5). Furthermore, over the same period the share of the region's imports subject to non-tariff barriers has declined from 31% to 11%. Specific tariffs have virtually disappeared even while they are still common in the industrialised economies (ECLAC, 1995; IDB, 1996).

Figure 5 Tariff Liberalisation in Latin America



Source: IDB, Department of Integration and Regional Programs, Division of Trade, Integration and Hemispheric Issues (weighted on imports).

(ii) Multilateral Liberalisation. The second level of external opening is multilateral. The region has assumed the new disciplines that emerged from the Uruguay Round. Indeed, it was the only developing region to bind 100% of its tariffs (although the binding was at a level more than double that of average applied tariffs). With Panama joining the WTO in 1995, all of the region is now subject to the rights and obligations of the WTO.

(iii) Regional Integration. The third tier of opening has been through regional integration. It is often overlooked that in the new context of policy change in Latin America, regional integration is an additional instrument to open economies to competition, and complementing levels one and two of the trade liberalisation process. Indeed, the insertion of regional integration initiatives into the overall liberalisation strategy of the 1990s gives the process the character of "open regionalism." Moreover, the fact that tariffs are different from zero, but generally at relatively moderate levels, leaves space for reciprocal tariff preferences with more limited trade diversion than in earlier trade agreements.

IV Why Do the Countries Pursue Regional Integration?

Regional integration has various dimensions. The simplest form of integration is a free trade area in goods only, in which there is a progressive elimination of tariffs on most trade among partner countries. The next level of commitment would be a more comprehensive free trade area that includes services and even WTO "plus" disciplines in other trade-related areas. Even deeper commitments would involve ceding sovereignty over commercial policy, by creating a customs union with a common external tariff protecting the liberalised sub-regional market. Deeper still is a common market with free movement of factors of production. All these schemes are currently reflected in the objectives of Latin America integration.

While the benefits and costs of integration depend on which type of scheme one is considering and the overall policy context, limits on space permit only some general appreciations in this regard.

A. Some Common Motivations for Regional Integration

Without being exhaustive and recognising that many goals can be interrelated, some frequently mentioned objectives are outlined below.

Politics

Many initiatives emerge under a political umbrella designed to bring nations closer to one another. The degree of commitment varies but the motive is often present. Latin Americans share a common heritage, language and culture. There is a side of Latin Americans that makes them like to be more together; these sentiments indeed extend back to Bolivar and independence. The phenomenon is sometimes hard for non-Latinos to understand and could seem contradictory given the long history of serious political disputes among Latin American nations. But the fact remains that the centrifugal forces of disagreement have co-existed with, and often have been overcome by, the centripetal forces of a common heritage and culture. These opposing forces of course can be especially intense in the various geographic sub-regions of Latin America.

Today's integration in Latin America is often driven by powerful political objectives. This is most clearly manifest in Mercosur (including associates Chile and Bolivia), where countries with a history of conflictive relations are using economic integration to draw themselves more closely together into a common purpose of peace and prosperity. A similar phenomenon can be found with the reactivation of integration in other subregions such as the Andean Community.

Practising the Art of the Possible in Trade Liberalisation

Unilateral and multilateral liberalisations are always staged. Unilateral liberalisation has the benefits of creating trade and raising competition through importables and lowering input costs; but it also has immediate fiscal costs and real resource costs through creating obsolete capital and redundant labour as well as public psychological costs because of the real and imagined threats of globalisation. Thus, the process of adjustment must move in tandem with the political and economic capacity to digest those costs. The large and rapid liberalisation of recent years encountered initially considerable "water" in national tariff schedules; and the necessary fiscal adjustments were quite straightforward. But now tariffs are presumably closer to actual differential margins of competitiveness between home and abroad, while fiscal options are narrower. The liberalisation process, however, is made more complicated by exchange rate appreciations that have taken place in the 1990s in a number of Latin American countries (which has further cut margins of protection) and the simultaneous action of stabilisation programmes which usually raise the cost and reduce the supply of domestic credit. Meanwhile, multilateral rounds come in spurts, the schedule of which is largely out of the control of developing countries. In the case of the Uruguay Round the region still is in the process of digesting existing commitments.

In this context, authorities can use regional integration as a window of opportunity to continue pursuing liberalisation, but in the more predictable and controlled environment of a reciprocal agreement of circumscribed scope. In fact, regional integration adds a compensatory ingredient to unilateral import liberalisation, by fostering reciprocal exports in tandem with reciprocal imports. Hence, the doses of positive and negative impulses to economic activity and investment are more balanced with regional integration, than is the case in pure unilateral import liberalisation. Moreover, the regional agreement does lower the average level of protection vis-à-vis the status quo, creating trade, raising competition and promoting specialisation in the sub-regional market. The arrangement can meet less political resistance (and indeed even be quite popular as in the case of Mercosur) because of a number of associated factors such as public sentiments about "getting together" with a known neighbour, compensation through reciprocity with guaranteed market access, and more limited impacts on fiscal income (the starting point for most integration agreements has involved modest levels of trade and rather symmetric tariff structures).[7]

Strategic Impulse to Development

Regional integration also builds on strategic considerations arising from imperfect and incomplete markets at home and abroad, which handicap the spread of efficiency gains in certain sectors and the development of new productive patterns with progressively higher degrees of value added.

The conventional literature on the benefits and costs of economic integration focuses on tariff preferences in a framework of optimal competitive equilibrium. This equilibrium is assumed to be disturbed only by the existence of import restrictions. In this framework, integration is beneficial only if it implies a move toward free trade; that is, if the effects of trade creation (shift toward cheaper sources of supply) are larger than those of trade diversion (shift toward more costly sources of supply).[8] The crucial issue, however, is how costs are measured; in the standard approach it is at actual market prices net of tariffs, assuming away transitional costs and incomplete markets, as well as acquirable competitiveness. The assumptions lead to the obvious conclusion that overall unilateral liberalisation is always the optimal national policy and better than regional integration.

But the real world is more complicated. For many non-traditional products, access to markets is more limited and unstable, making economies of scale, the emergence of externalities of location and agglomeration, and specialisation more difficult to achieve. It is for these types of products that regional integration becomes a potential platform for diversifying growth of exports, and to improve trade's contribution to development. In the face of distortions in world markets, guaranteed access to regional foreign markets can be a catalyst for exploiting potential externalities; indeed, this is a leading objective of policymakers and a major force encouraging regional integration. Moreover, in face of economies of scale, what otherwise would be a costly trade diversion can become a cost-reducing and welfare-enhancing effect (Corden, 1972; Ffrench-Davis, 1980).

7 A regional arrangement can additionally serve to lock-in policy commitments that otherwise are more easily reversible. North-South agreements in particular are often cited for these confidence-building effects (Fernandez, 1997). A good example is the incorporation of Southern Europe into the EU, which was instrumental in the former's economic transformation and consolidation of democracy.

8 There is also the effect à la Lipsey, of an eventual reduction of price distortions on consumption.

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Meanwhile, local factor markets are incomplete or distorted. Labour training, technology and long-term capital are scarce, with inexistent or infant markets, and foreign direct investment (FDI) – a potential bearer of some of these scarce factors – is frequently coquettish, playing one national suiter off against the other in a world of imperfect information.[9] These market failures are more significant for non-traditional exports of differentiated products, whether of natural resources, manufactures or exportable services. If access to external markets is improved for these exportables, it can be a catalyst for completing markets and diluting segmentation.

Infrastructure, trade financing and knowledge of markets (marketing channels, organised transportation, standards, etc.) have often been biased against intra-regional trade in LDCs. All these "factors" of trade have been traditionally more developed for transactions with the great metropolitan centres (often linked to the cumulative effects of a colonial past) while they are inexistent or rudimentary for trade among LDCs neighbours. This is a significant variable explaining why intra-regional trade has been lower among Latin American countries than what the gravity of geography would often suggest.

These are serious restrictions on the expansion of production and trade in goods and services with relatively more knowledge content and longer learning curves, elements which are now recognised as key components of the growth process. Regional integration can be a strategic tool to partially overcome these obstacles by:

- expanding market size to facilitate greater specialisation and industrialisation through economies of scale and possibilities to exploit economies associated with the agglomeration of production activity.
- enhancing the forces of competition, enlarging a market with guaranteed reciprocal access, and intensifying the specificity of information flows, all of which in turn should induce new domestic investment and permit better conditions to attract efficient foreign investment.
- creating the security of sub-regional market access, preferences, and exploiting the familiarity of neighbourhoods, which combine to accelerate the emergence of new exporters of manufactured goods. In effect, the learning curve associated with sub-regional export experience can serve as a platform for new international exports. This is an important consideration since history has shown that developing countries can achieve new dynamic comparative advantage on the road of their long-term convergence with industrialised countries.[10]

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9 Moreover, it must be recalled that FDI represents only 6 to 10% of capital formation in the world.

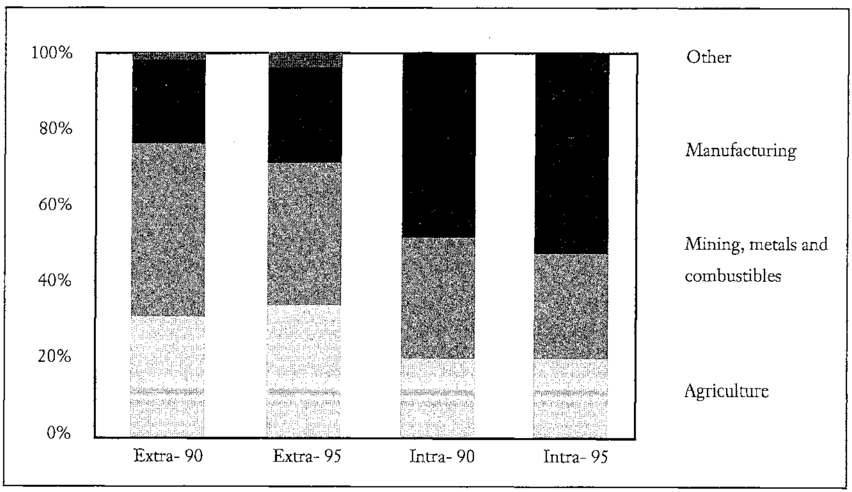
10 For an example of intra-industry trade patterns set off by an important sub-regional agreement, see Echavarria (1997).

The expected enhanced international competitiveness brought about by regional integration should build confidence and prepare countries for globalisation and further advances in multilateral liberalisation. And as mentioned earlier, regional integration can also be viewed as a way to move ahead with liberalisation while the region awaits consensus on development of a new round of reciprocal multilateral disciplines.

To appreciate the strategic dimension of integration it is useful to examine the profile of intra-regional exports. Intra- and extra-regional exports from Latin America display marked differences in terms of their product structure and technological content, with manufactures accounting for a much larger share of intra-regional commerce. This pattern is evident even if Mexico – whose *maquila* trade with the United States accounts for a large share of Latin America's overall exports – is discounted from the regional average. Excluding Mexico, manufactures account for approximately 50% of intra-regional exchanges, compared to around 23% for extra-regional exports (Figure 6). The annex to this article discusses the composition of intra-regional exports and their technological content in more detail.

All these aspects of regional integration are of course potential developments rather than guaranteed outcomes; what happens in practice depends on the nature of policy implementation, a point we will return to in the concluding section.

Figure 6 LAC Exports by Sector (excluding Mexico)



Source: IDB, Department of Integration and Regional Programs, Division of Trade, Integration and Hemispheric Issues (weighted on imports).

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B. The Costs of Regional Integration

The potentially positive aspects of regional integration are accompanied by costs too. Some of these have received much attention in the literature of late. A brief summary of the most frequently cited costs would be:

1. Preferences in regional trading arrangements can divert trade away from possibly more efficient firms which are located in non-member countries (Yeats, 1996; Bhagwati and Panagariya, 1996). This has costs for the non-member countries that lose market share. The trade diversion risks locking the partner economies into patterns of inefficient production.
2. Regional integration agreements can improve the terms of trade of member countries at the expense of non-member countries and give rise to incentives for maintaining or increasing preferences and protection.[11]
3. When there are serious asymmetries in average tariff levels among prospective partners of an integration agreement, the loss of tariff revenue in the preferential liberalisation process can have serious redistributive effects among the countries (Panagariya, 1996). In effect, part of what would have been realised as tariff revenue on imports from the partner country prior to the agreement is transferred to the partner's producers, as tariffs are preferentially eliminated.
4. While regional integration can clearly induce foreign direct investment in the expanded sub-regional market (Bloomstrom and Kokko, 1997), this is an expensive source of financing for which compensating positive spillovers can be ambiguous. Integration induced investment can also involve diversion of FDI from more efficient non-members (Winters, 1997).
5. In regional integration, benefits are often asymmetrically distributed and initially concentrated in some members while others are dependent on uncertain spillover effects (Puga and Venables, 1997).
6. An explosion of free trade areas creates a spaghetti pattern of agreements with multiple hubs and spokes that give rise to distortions in trade, excessive administrative costs, rent seeking and a difficult to predict distribution of gains among countries (Wonnacott and Wonnacott, 1995).
7. The emergence of regional agreements creates defensive reactions, in which a country joins an agreement not because it is the best option, but

11 Looked at from another angle, rather than improving the terms of trade, regional integration may be able to soften a worsening of the terms of trade that could occur if Latin American countries keep on producing more of the same basket of traditional exports.

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because of the real or potential costs of being left out of an integration process.
8. Regional integration distracts attention from multilateral rounds of liberalisation and delays further unilateral opening.

V Putting the Costs and Benefits into Perspective

Evaluating regional integration processes and their costs and benefits is no easy task. Part of the problem is the nature of the subject matter.

First, regional integration is a complex general equilibrium phenomenon with dynamic processes, making it difficult to dissect for purposes of causal explanation. The process involves issues that link growth to technology, learning, externalities, political economy and politics, all of which economists have trouble grappling with at a national level not to mention among several countries simultaneously. A further complication which one finds in Latin America is that the integration processes are an integral part of the profound structural reforms that have touched all levels of the economy and create big changes. Moreover, initial conditions, and the phases and sequencing of these reforms, are usually quite different among the partner countries.

Second, regional integration is a medium/long-term process. When successful, one expects to see initial costs compensated by benefits that play out over the medium to long-term.

Third, regional integration is very much a second-best world where generic prescriptions can be especially dangerous.

Fourth, regional integration is typically evaluated in light of what would have happened in its absence. Moreover, economists are interested in measuring changes in welfare; given the complications of defining this for a particular sub-region they often use a proxy expressed in a summary statistic reflecting growth or trade (Winters, 1997).

These characteristics place great burdens on analysts. It is well known that counterfactual analysis faces a daunting epistemological problem: contrary to fact, conditionals can never be verified by realising their antecedent (the "if" clause); thus the resulting explanation is never correct or incorrect but rather only persuasive or not persuasive. We also know that counterfactuals are more likely to be persuasive: (i) the more simple the causal process studied; (ii) the shorter the time period in question; (iii) the smaller the changes considered; and (iv) the less analysis turns on exact magnitudes. Reflecting back on the characteristics of integration processes it can be seen that our counterfactual analysis is challenged on all these counts.

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Conclusions about regional integration are rarely based on the entire story. Much of the debate centres on static trade creation and trade diversion effects, first pointed out by Viner (1950). This is partly because many economists consider these effects to be the fundamental dimension for evaluating regional integration. One problem, however, is that the static analysis frequently uses a partial competitive equilibrium framework to jump to general conclusions about a process that is a general equilibrium phenomenon. Worse, the existence of trade diversion alone (never mind the net effects with trade creation) in new integration agreements has been sufficient for some to categorically condemn them and regional integration more generally (Yeats, 1996).[12]

But more importantly, conventional trade creation vs. diversion is clearly only part of the story and many other economists (e.g., Mistry, 1996; Fernandez, 1997 and the authors) would argue that it is not the major part. This is because the net benefits of the dynamics of integration can be several times larger than their static reallocation effects. Problems exist here too because our models of dynamics and empirical foundations for testing them are very deficient, so much so that some have even characterised analysis in this area as "mystical" (Winters 1997). It is true that the empirical foundation of dynamic analysis is still weak. Nevertheless, the models of dynamics are sufficiently specified to suggest that the benefits behind the dynamics of integration are potentially large. It therefore is worth the effort to go beyond static trade creation-diversion analysis (which has its ambiguous dimensions as well) to begin to better understand, even if only very imperfectly, the longer-term dynamics.

The empirical bottlenecks to understanding Latin American integration should not be underestimated. Even basic data such as the evolution of preferences, rules of origin, non-tariff measures, intra-regional investment flows, firms' cost structures, etc., are unavailable or incomplete. The many gaps sometimes induce questionable *ad hoc* compromises in our analytical techniques or cause us to ignore important phenomena altogether through the convenient use of the *ceteris paribus* clause. Better data development and more field research will not eliminate the debate over regionalism but it would certainly help to ground the debate more in reality; and it may also help to narrow our differences.

The starting point is to better complement our powers of scientific

12 This latter study set off a major controversy by concluding that Mercosur was harmful to itself and the rest of the world due to trade diversion. It concluded this by discovering intense intra-regional trade in some sectors with high preferences. The study, however, did not control for the fact that protection might be independent of Mercosur nor for other potentially important explanatory factors, and overlooked indications of much trade creation in the 1990s (see Devlin, 1997 and IDB, 1996b).

deduction with much more empirical field work and case studies of the disaggregated dimensions of the dynamics of regional integration. In other words, instead of examining what would have happened in the absence of integration we might want to spend more time discovering what is actually happening and how it is happening in Latin American integration. In effect, one would examine the different objectives of a specific integration arrangement, see whether these different objectives are being realised, and begin to catalogue the causal factors contributing to developments without necessarily being overly concerned about precise weights. For example, one frequently stated objective of regional integration is to enhance competition; hence we can examine how sectoral markets are changing their competitive structure and the forces behind that. Is intra-industry specialisation increasing in the sub-regional market? Are the different parameters of the integration agreement stimulating firms to invest? Are firms' technology and cost structures improving in the direction of greater international competitiveness and is there room to reduce preferences? Are new international exports and comparative advantages emerging out of experiences in the sub-regional market?

This type of research is at "ground zero" and examines the integration agreement from the bottom up. Field research does not generate elegant analytical structures. It is time consuming and expensive, often requiring the building of primary data bases. It also will not generate summary statistics of welfare or permit categorical evaluations of integration processes. But it has four potential benefits:

1. It will allow for better observation of what is actually happening in the different dimensions of integration. The analyst gets "inside" the process where the action is and examines the dynamics of sectoral markets and firms which actually move the process forward.
2. By working at relatively low levels of aggregation one might be able to identify causal factors that are not easily captured in existing theory or more aggregated analysis.
3. While such analysis will not permit the adding up of effects into a summary statistic of welfare, the examination of multiple disaggregated dimensions of an integration process will permit a series of analytical vignettes which taken together can build a tentative story of whether the integration process is achieving expected goals in strategic areas.
4. The empirical work will feed our economic modelling of integration with better informed assumptions and better data for testing.

In sum, the suggested approach of more intensive interaction between deductive and inductive methods should enhance our powers of discovery and evaluation of a process that is ever more present in our world economy.

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Until we have better ability to measure and evaluate the *full* story of integration we should be careful about our evaluations. Any major transformation has costs, usually concentrated up front. Therefore it is no surprise that regional integration has costs. For instance, since regional integration is a strategic compromise among economies with different economic and political characteristics, a degree of unwanted trade diversion is inevitable.[13] However, countries justify these costs by the greater benefits that are expected, which are derived from a combination of political returns, lock-in effects, trade creation and the aforementioned dynamic forces of transformation which are spread out over a longer period of time.

Thus when examining up-front costs, analysts should be careful to interpret them as only a piece of a story which plays out over a longer term, and thereby refrain from categorical overall assessments, except in the most extreme cases. Meanwhile, since regional integration is a strategic decision, participants should have their objectives clearly articulated. One objective is to minimise costs; thus any constructive analysis that sheds light on them would also be welcome. Moreover, vigilance about costs is extremely important. On the one hand, while fashionable, not all integration arrangements make economic sense. On the other, even those that do can potentially go awry. Finally, there are systemic costs arising from the sum effect of many regional initiatives which individually may make sense.[14]

VI Conclusions

Regional integration is a fact of life in Latin America and indeed in most of the world. Regional integration is being pursued in Latin America for political reasons as well as for its value as a strategic tool of development in a second-best world. No one denies that it can have important costs. But much of the attention on costs has been focused on the short-term up-front costs that are part of any major transformation. These costs must be

13 As mentioned earlier, in a "dynamic" setting some trade diversion could be a benefit to the extent it ultimately would contribute to lower costs, increased competitiveness and growth.

14 The clearest example of this is the spaghetti effect of many integration arrangements in the hemisphere which reduce transparency and raise transaction costs. However, the problem may be less severe than appears at first blush because the majority of arrangements follow the umbrella concepts laid out by ALADI (e.g., Chilean bilaterals) or NAFTA (e.g., the Mexican bilaterals). Moreover, the complex network of arrangements provides incentives for consolidation, as witnessed in Mercosur's emerging free trade association in South America, the Free Trade of the Americas process and, perhaps someday soon, at the world level in a new multilateral round aiming at a target of zero tariffs (which would eliminate the simplest free trade areas).

measured against the benefits, and the bulk of these are expected in the medium to long-term through the dynamics of economic transformation. These dynamic processes could be better understood and measured if more attention were given to micro and sectoral field research where much of the process of regional integration takes place. This ground zero research would complement our more aggregate analysis and model building.

Since regional integration is here to stay, it would be constructive to promote policies that are likely to minimise the risks of unacceptable costs and to amplify potential benefits. Some of the major challenges in this regard are:

1. *Progressive Elimination of Imperfections in Sub-Regional Integration Schemes*

There is a need for full implementation of agreements and effective enforcement. Politically feasible formulas are needed to gradually eliminate existing exceptions to agreed trade liberalisation because the opening up of sensitive sectors is usually very rich in trade creation effects. Integration of services is largely a frontier that still must be crossed, but special caution is needed regarding integration of financial services due to potential negative macroeconomic side effects (Zahler and Budmevich, 1997). Remaining trade distorting non-tariff measures (NTMs) must be eliminated or harmonised to the extent possible, and very importantly, rules of origin in free trade areas should be gradually substituted for common external tariffs or, alternatively, simplified and relaxed sufficiently (within the confines of rigour) to respect the status quo in trade patterns (Garay and Estevadeordal, 1995; Simpson,1997; Serra *et al.*, 1996). Latin America must also substitute its tradition of settling disputes through diplomatic channels (perhaps effective when the economies were state dominated) for modern transparent dispute settlement mechanisms (Devlin, 1995). Now that private markets are the driving force of the economy, it is necessary that integration arrangements are transparently rule-based; only in this way will the full potential for productive private investment – that is so important for the efficient specialisation which is at the heart of successful integration agreements – be realised.

Rationalisation of regional institutions is necessary. In the case of some traditional integration schemes which modelled themselves after Europe, the task is to downsize an overdimensioned and underfinanced institutional structure. For the new schemes of the 1990s the task is just the opposite: fortify incipient institutional arrangements so that instruments are compatible with objectives. Of particular concern for ambitious integration schemes is the need to have mechanisms in place to ward off dangerous imbalances in the distribution of costs and benefits of the process. Another area of concern is infrastructure (Vera, 1997). There is a need to create effective institutional mechanisms for the coordination of regional infrastructure networks and their financing, in order to better exploit the advantages of location.

Finally, integration schemes, especially deep ones, must improve official mechanisms for the interchange of information and analysis on macroeconomic developments in the sub-regions and monitor the processes of convergence which should emerge (Ben-David, 1996).

2. *Consolidation and Deepening of Structural Economic Reforms*

These reforms, including those leading to macroeconomic stability, have been underlying the recent success of intra-regional trade. However, there is concern that exchange rate appreciation linked to capital surges and indiscriminately open capital accounts, coupled with the use of the exchange rates primarily as anchors of domestic prices, is distorting resource allocation and trade, and may reduce the sustainability of macroeconomic balances and their contribution to growth (IDB, 1997; Ffrench-Davis, 1996). Sometimes short-run targets of stabilisation also have tended to contribute to a weakening of mesoeconomic policies (such as education, labour training, support to technological improvement of medium and small firms, infrastructure). All this tends to differ the reaping of profitable opportunities in processes of economic integration and opening, and worsens the balance of benefits and costs. In extreme instances of instability in the face of volatile capital flows, it would actually threaten the viability of the integration project itself. There clearly is a need to foster development of more direct instruments for stabilisation policy.

3. *Operational WTO Review of Regional Integration Processes*

Article XXIV of the GATT and Article V of the GATS are meant to ensure consistent, fair and transparent multilateral monitoring of integration arrangements. However, the articles and their implementation, even with the important clarifications of the Understanding attached to Article XXIV in the Uruguay Round, still suffer from a degree of imprecision. The doubts that sometimes are raised about regional integration could be more constructively dealt with in the context of operational Article XXIV reviews with multilaterally agreed criteria and strong empirical foundations (Serra *et al.*, 1996). Moreover, improved multilateral guidelines would help to broaden the common base among agreements and mitigate the potential costs of the spaghetti bowl of arrangements in the hemisphere and the world.

As long as countries are clear in their strategic objectives for an integration agreement, are vigilant of costs, continue to remedy shortcomings and ensure that the process remains an integral part of an overall policy framework of structural economic reform, there is good reason to be cautiously optimistic about the ability of regional initiatives to serve as an effective instrument of growth and development. The other essential element for Latin America and the rest of the world is further development of the multilateral system. Latin America has a vested interest in ensuring that regionalism is consistent with a healthy and progressively more liberalised rules-based world trading system, if for no other reason that 80 percent of its trade is extra-regional. Fortunately, there is growing consensus among economists and policymakers about the potentially positive contribution that the new "open" regional integration can make to the world trading system. The trend is well captured in a recent WTO Secretariat study which states "...to a much greater extent than is often acknowledged, regional and multilateral integration initiatives are complements rather than alternatives in the pursuit of more liberal and open trade" (WTO, 1995: 56).

Annex

The Composition and Technological Content of Intra-Regional Trade

Composition of Intra-Regional Trade

The Latin American economies provide very important and dynamic markets for the sales of manufactures for many countries of the region (ECLAC, 1994). For instance, for Argentina, Chile, Colombia, Uruguay and Venezuela, this is by far the biggest market, be it for traditional industries, basic inputs or new industries. Latin America continues to be the almost exclusive destination for exports from the new industries of several countries; these exports have been markedly dynamic in the 1990s. The same is true of their respective sub-regional market as regards the new industries of Costa Rica and Guatemala. Brazil has channelled its export manufactures to different markets; the United States continues to be the main buyer of traditional industries, followed by Europe. As for basic inputs, other developing regions have displaced Latin America as the main destination, but in the case of new industries, the region is the most important market for Brazil. An exception is the case of Mexico, where the regional market has less relative importance than the United States.[1]

Technological Intensity

Development based on a growing and sustained international competitiveness is boosted by the dynamic effects derived from technological apprenticeship. The strategies to improve international linkages, based on productive development, emphasise the role played by trade in the process of stimulating the development of activities which make intensive use of knowledge and technology. In this sense, it is interesting that trade among developing countries is characterised by concentration in goods that are more technology-intensive than exports from developing to industrial countries.

This is the broad conclusion of a study by Buitelaar (1993) which combines

1 Regressions carried out by ECLAC for the period 1970-91 show that there was a strong positive relationship between the importance of Latin America as a destination and the share of new industrial products in total exports of Argentina, a relationship that is positive but less intense for Brazil. In Chile, the exercise revealed a strong positive correlation for all manufactures. For Mexico, however, no significant relationship was obtained.

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data on foreign trade and on production. Three main conclusions emerge from the research:

i) The production of goods which depend to a greater extent on intra-regional trade has more sophisticated technological features. Such goods are to be found mainly in the chemical sector, non-electrical machinery and transport equipment. They are also sectors in which international demand tends to be more dynamic. Their price trends (factorial terms of trade) are more stable and evolve more positively over the long-term than prices of traditional exports.

ii) The sectors which exhibit a strong export drive toward the region also tend to show (sometimes with a lag) a drive towards extra-regional markets, which suggests that the promotion of intra-regional trade complements the promotion of extra-regional exports.

iii) These same sectors are those in which the region has a high dependency as regards extra-regional intermediate imports, and therefore intra-regional trade benefits from having access to inputs and equipment which may be imported from third countries. Thus, relaxation of excessive extra-regional import restrictions has contributed to foster and upgrade intra-regional exports.

To sum up, intra-regional trade, because of its characteristics, associated with location and the diverse channels which facilitate such trade, complements the Latin American countries' linkages with the global economy and provides a dynamic context of technological apprenticeship, leading to greater international competitiveness and a more diversified, balanced pattern of specialisation.

Table 1 Recent Regional Trade Agreements in Latin America1

Year	Agreement	Some agreements in discussion2
1990[3]	Andean Pact[4]	Caricom[5] – Central America
1991[6]	Central American Common Market[7]	Dominican Republic – Caricom
1991	Chile – Mexico	Dominican Republic – Central America
1991	Mercosur[8]	Chile – European Union
1993	Chile – Colombia	Chile – Central America
1993	Chile – Venezuela	Mexico – El Salvador, Guatemala, Honduras
1993	NAFTA[9]	
1994	Chile – Ecuador	Mexico – Belize
1994	Mexico – Bolivia	Mexico – European Union
1994	Mexico – Costa Rica	Mexico – Ecuador
1994	G-3[10]	Mexico – Peru
1996	Chile – Mercosur	Mexico – Panama
1997	Bolivia – Mercosur	Mercosur – Andean Community
1997	Chile – Canada	Mercosur - European Union
1998	Mexico – Nicaragua	

Notes:

1 Excludes partial agreements of the Latin American Integration Association (LAIA or ALADI in Spanish).
2 In different stages of development.
3 Date of reactivation of the free trade zone.
4 The Andean Pact includes Bolivia, Colombia, Ecuador, Peru and Venezuela.
5 The Caribbean Community includes Antigua and Barbuda, Bahamas, Barbados, Belize, Dominicana, Grenada, Guyana, Jamaica, Montserrat, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Trinidad and Tobago.
6 Date of reactivation of the free trade zone.
7 The Central American Common Market includes Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua.
8 Mercosur includes Argentina, Brazil, Paraguay and Uruguay.
9 NAFTA includes Mexico, Canada and U.S.A.
10 The G-3 includes Colombia, Mexico and Venezuela.

Source: IDB, Department of Integration and Regional Programs, Division of Integration, Trade and Hemispheric Issues.

Table 2 **Western Hemisphere: Total and Intraregional Exports1**
(millions of dollars and percentages)

	1990	1991	1992	1993	1994	1995	1996	1990-96 average2
Western Hemisphere3								
Global Exports	658,234	684,995	727,241	765,511	859,185	996,945	1,067,489	
% growth	7.9	4.1	6.2	5.3	12.2	15.9	7.2	8.4
Extra Hemispheric Exports	341,515	357,391	364,017	365,905	394,303	472,187	493,073	
% growth	5.4	4.6	1.9	0.5	7.8	19.8	4.4	6.3
Intra-Hemispheric Exports	316,719	327,605	363,224	399,606	464,881	523,858	574,417	
% growth	10.7	3.4	10.9	10.0	16.3	12.7	9.7	10.4
Intra-Total	*48.1*	*47.8*	*49.9*	*52.2*	*54.1*	*52.6*	*53.8*	
Latin America and the Caribbean4								
Global Exports	137,781	136,242	145,504	155,644	181,573	218,989	242,758	
% growth	10.5	-1.1	6.8	7.0	16.7	20.6	10.9	9.9
Extra-LAC Exports	121,412	116,249	120,662	126,011	146,574	177,194	198,056	
% growth	10.9	-4.3	3.8	4.4	16.3	20.9	11.8	8.5
Intra-LAC Exports	16,369	19,993	24,843	29,633	34,998	41,795	44,702	
% growth	7.3	22.1	24.3	19.3	18.1	19.4	7.0	18.2
Intra-Total	*11.9*	*14.7*	*17.1*	*19.0*	*19.3*	*19.1*	*18.4*	
Latin America and the Caribbean (excluding Mexico)								
Global Exports	97,070	93,555	99,309	103,758	119,596	139,212	147,789	
% growth	8.4	-3.6	6.1	4.5	15.3	16.4	6.2	7.3
Extra-LAC Exports	82.223	75,317	76,771	76,678	87,204	101,515	108,050	
% growth	8.5	-8.4	1.9	-0.1	13.7	16.4	6.4	4.7
Intra-LAC Exports	14,847	18,238	22,538	27,079	32,392	37,696	39,739	
% growth	7.5	22.8	23.6	20.1	19.6	16.4	5.4	17.8
Intra-Total	*15.3*	*19.5*	*22.7*	*26.1*	*27.1*	*27.1*	*26.9*	
Central American Common Market								
Global Exports	4,058	4,138	4,697	5,065	5,509	6,864	7,676	
% growth	12.7	2.0	13.5	7.8	8.8	24.6	11.8	11.2
Extra-CACM Exports	3,402	2,356	3,697	3,961	4,280	5,408	6,149	
% growth	12.4	-1.3	10.1	7.1	8.1	26.4	13.7	10.4
Intra-CACM Exports	656	782	1,000	1,105	1,229	1,456	1,527	
% growth	14.6	19.1	27.9	10.4	11.3	18.4	4.9	15.1
Intra-Total	*16.2*	*18.9*	*21.3*	*21.8*	*22.3*	*21.2*	*19.9*	
Andean Community								
Global Exports	31,605	28,630	28,380	29,654	34,256	38,843	42,656	
% growth	26.1	-9.4	-0.9	4.5	15.5	13.4	9.8	5.1
Extra-Andean Exports	30,310	26,912	26,224	26,858	30,852	34,268	38,027	
% growth	26.2	-11.2	-2.6	2.4	14.9	11.1	11.0	3.9
Intra-Andean Exports	1,295	1,719	2,156	2,796	3,404	4,575	4,629	
% growth	23.5	32.7	25.4	29.7	21.7	34.4	1.2	23.6
Intra-Total	*-1.1*	*6.0*	*7.6*	*9.4*	*9.9*	*11.8*	*10.9*	

zFrom: Regional Integration and Multilateral Cooperation in the Global Economy
FONDAD, The Hague, 1998, www.fondad.org

Table 2 (continued)
(millions of dollars and percentages)

	1990	1991	1992	1993	1994	1995	1996	1990-96 average2
Mercosur								
Global Exports	46,425	45,911	50,561	54,162	62,112	70,401	75,030	
% growth	-0.3	-1.1	10.1	7.1	14.7	13.3	6.6	8.3
Extra-Mercosur Exports	42,302	40,808	43,341	44,132	50,157	56,018	58,881	
% growth	-1.2	-3.5	6.2	1.8	13.7	11.7	5.1	
Intra-Mercosur Exports	4,123	5,102	7,220	10,031	11,955	14,384	16,149	
% growth	10.8	23.8	41.5	38.9	19.2	20.3	12.3	25.6
Intra-Total	*8.9*	*11.1*	*14.3*	*18.5*	*19.2*	*20.4*	*21.5*	
NAFTA								
Global Exports	561,164	591,440	627,993	661,752	738,494	856,598	920,678	
% growth	7.8	5.4	6.2	5.4	11.6	16.0	7.5	8.6
Extra-NAFTA Exports	320,667	341,997	354,468	360,444	386,434	461,078	483,655	
% growth	5.2	6.7	3.6	1.7	7.2	19.3	4.9	
Intra-NAFTA Exports	240,497	249,443	273,465	301,308	352,060	395,520	437,023	
% growth	11.5	3.7	9.6	10.2	16.8	12.3	10.5	10.5
Intra-Total	*42.9*	*42.2*	*43.6*	*45.5*	*47.7*	*-16.2*	*47.5*	
Group of Three								
Global Exports	65,162	65,117	67,451	74,367	86,020	107,625	126,836	
% growth	22.2	0.9	36.1	10.3	17.1	23.8	16.7	11.7
Extra-Group of Three Exports	64,127	63,937	65,675	72,023	83,456	104,319	123,596	
% growth	15.5	-0.3	2.7	9.7	15.9	25.0	18.5	11.6
Intra-Group of Three Exports	1,305	1,180	1,776	2,344	2,565	3,306	3,240	
% growth	47.0	14.0	50.4	32.0	9.4	28.9	-2.0	20.9
Intra-Total	*1.6*	*1.8*	*2.6*	*3.2*	*3.0*	*3.1*	*2.6*	

Note: 1 Mexico's exports include maquila.
2 Average for Caricom is 1990-1995.
3 Western Hemisphere includes Latin America and the Caribbean (see following definition), the United States and Canada.
4 Latin America and the Caribbean here is Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay, Venezuela, Bahamas, Barbados, Belize, Guyana, Jamaica, Trinidad and Tobago, Haiti and the Dominican Republic.

e = estimate

Source: IADB, Department of Integration and Regional Programmes, Division of Integration, Trade and Hemispheric Issues, based on DATAINTAL. Caribbean, US and Canadian data, as a source country, are from IMF, *Direction on Trade and Statistics.*

Table 3 Western Hemisphere: Total and Intraregional Imports1
(millions of dollars and percentages)

	1990	1991	1992	1993	1994	1995	1996	1990-96 average2
Western Hemisphere[1]								
Global Imports	747,493	758,937	836,042	913,399	1,046,065	1,161,200	1,238,749	
% growth	5.4	1.5	10.3	9.1	14.5	11.0	6.7	8.8
Extra Hemispheric Imports	431,751	423,603	459,534	512,927	585,874	642,112	672,737	
% growth	4.5	-1.9	8.5	11.6	14.2	9.6	4.8	7.7
Intra-Hemispheric Imports	315,743	335,334	377,507	400,473	460,191	519,088	566,012	%
growth	6.6	6.2	12.6	6.1	14.9	12.8	9.0	10.2
Intra-Total	*-12.2*	*44.2*	*45.1*	*43.8*	*44.0*	*44.7*	*45.7*	
Latin America and the Caribbean[4]								
Global Imports	110,235	128,880	157,007	174,272	205,546	226,317	250,306	
% growth	11.9	16.9	21.8	11.0	17.9	10.1	10.6	14.6
Extra-LAC Imports	93,221	108,082	131,190	144,680	171,237	183,965	204,990	
% growth	12.1	15.9	21.4	10.3	18.4	7.4	11.4	14.0
Intra-LAC Imports	17,014	20,798	25,817	29,592	34,310	42,352	45,317	
% growth	11.0	22.2	24.1	14.6	15.9	23.4	7.0	17.7
Intra-Total	*15.4*	*16.1*	*16.4*	*17.0*	*16.7*	*18.7*	*18.1*	
Latin America and the Caribbean (excluding Mexico)								
Global Imports	68,643	78,914	94,877	109,163	125,367	153,876	162,140	
% growth	7.7	13.0	20.2	15.1	14.8	22.7	5.4	15.4
Extra-LAC Imports	52,685	59,703	71,021	81,874	93,983	113,531	118,979	
% growth	6.9	13.3	19.0	15.3	14.8	20.8	4.8	14.5
Intra-LAC Imports	15,958	19,210	23,855	27,289	31,384	40,345	43,161	
% growth	10.1	20.4	24.2	14.4	15.0	28.6	7.0	18.0
Intra-Total	*23.2*	*24.3*	*25.1*	*25.0*	*25.0*	*26.2*	*26.6*	
Central American Common Market								
Global Imports	6,535	6,868	8,874	9,456	19,224	12,087	12,304	
% growth	6.0	5.1	29.2	6.6	8.1	18.2	1.8	11.1
Extra-CACM Imports	5,895	6,058	7,805	8,326	8,950	10,580	10,743	
% growth	6.2	2.8	28.8	6.7	7.5	18.2	1.3	10.5
Intra-CACM Imports	640	810	1,069	1,131	1,274	1,507	1,561	
% growth	3.9	26.5	32.0	5.8	12.7	18.3	3.6	16.0
Intra-Total	*9.8*	*11.8*	*12.0*	*12.0*	*12.5*	*12.5*	*12.7*	
Andean Community								
Global Imports	17,425	22,3111	27,220	29,398	30,617	38,300	36,814	
% growth	3.0	28.0	22.0	8.0	4.1	25.1	-3.9	13.3
Extra-Andean Imports	16,243	20,665	25,129	26,753	27,345	33,423	31,954	
% growth	1.5	27.2	21.6	6.5	2.2	22.2	-4.4	11.9
Intra-Andean Imports	1,182	1,646	2,091	2,645	3,272	4,877	4,860	
% growth	30.4	39.3	27.0	26.5	23.7	49.1	-0.4	26.6
Intra-Total	*6.8*	*7.4*	*7.7*	*9.0*	*10.7*	*12.7*	*13.2*	

zFrom: Regional Integration and Multilateral Cooperation in the Global Economy
FONDAD, The Hague, 1998, www.fondad.org

Table 3 (continued)
(millions of dollars and percentages)

	1990	1991	1992	1993	1994	1995	1996	1990-96 average2
Mercosur								
Global Imports	27,326	32,140	38,536	47,823	61,851	75,311	83,217	
% growth	12.3	17.6	19.9	24.1	29.3	21.8	10.5	20.4
Extra-Mercosur Imports	23,204	27,016	31,266	38,427	49,989	61,218	66,125	
% growth	13.1	16.4	15.7	22.9	30.1	22.5	8.0	
Intra-Mercosur Imports	4,122	5,125	7,270	9,396	11,862	14,094	17,092	
% growth	8.0	24.3	41.9	29.2	26.2	18.8	21.3	26.8
Intra-Total	*15.1*	*15.9*	*18.9*	*19.6*	*19.2*	*18.7*	*20.5*	
NAFTA								
Global Imports	687,850	680,023	742,165	804,493	919,866	1,007,336	1,076,608	
% growth	5.2	0.2	9.1	8.4	14.3	9.5	6.9	8.0
Extra-NAFTA Imports	443,190	430,927	462,031	510,164	578,310	627,931	655,530	
% growth	4.8	-2.8	7.2	10.4	13.4	8.6	4.4	
Intra-NAFTA Imports	235,660	249,096	280,134	294,329	341,556	379,405	421,078	
% growth	5.9	5.7	12.5	5.1	16.0	11.1	11.0	10.2
Intra-Total	*34.7*	*36.6*	*37.7*	*36.6*	*37.1*	*37.7*	*39.1*	
Group of Three								
Global Imports	54,168	66,073	82,264	86,588	100,433	97,549	111,838	
% growth	14.4	22.0	24.5	5.3	16.0	-2.9	14.6	12.8
Extra-Group of Three Imports	53,450	65,110	80,795	84,626	98,242	94,379	108,600	
% growth	14.2	21.8	24.1	4.7	16.1	-3.9	15.1	
Intra-Group of Three Imports	719	963	1,470	1,963	2,191	3,170	3,238	
% growth	31.7	34.0	52.6	33.6	11.7	44.7	2.1	28.5
Intra-Total	*1.3*	*1.5*	*1.8*	*2.3*	*2.2*	*3.3*	*2.9*	

Note: 1 Mexico's exports include maquila. In principle, intraregional imports should equal intraregional exports. Slight variations between values of intraregional exports from Table 2 and intraregional imports in this table are due to exporting differences between the countries.
2 Average for Latin America and the Caribbean is for 1990-1996.
3 Western Hemisphere includes Latin America and the Caribbean (see following definition), the United States and Canada.
4 Latin America and the Caribbean here is Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay, Venezuela, Bahamas, Barbados, Belize, Guyana, Jamaica, Trinidad and Tobago, Haiti and the Dominican Republic.

e = estimate

Source: IADB, Department of Integration and Regional Programmes, Division of Integration, Trade and Hemispheric Issues, based on DATAINTAL. Caribbean, US and Canadian data, as the source country, are from IMF, *Direction of Trade and Statistics*.

Table 4 Selected Latin America Free Trade Agreements: Excepted Products
(number of tariff lines)

Sectors (SITC Rev. 2)	Canada to Mexico	Chile to Colombia	Colombia to Chile	Chile to Ecuador	Chile to Venezuela	Colombia to Mexico	Mexico to Colombia	Costa Rica to Mexico	Mexico to Costa Rica	Mexico to Chile	Chile to Mexico	Mexico to Venezuela
Food and live animals chiefly for food	72	128	128	114	46	203	115	85	51	35	38	114
Beverages and tobacco		6	7		6	14	3	15	3	6	6	3
Crude materials, inedible, except fuels		15	14	17	24	39	136	4	7	1	13	177
Minerals fuels, lubricants and related materials		15	24	16	15					17	18	
Animal and vegetable oils, fats and waxes	1	38	46	56	25	46	7	1	1	30	25	7
Chemicals and related products, N.E.S.	4	43	52	17	32	56	83	7	3			51
Manufactured goods classified chiefly by material		215	161	4	43	31	103					605
Machinery and transport equipment		172	9	3	153	26	65					15
Miscellaneous manufactured articles		40	37	2	6	180	146					145
Commodities and transactions not classified elsewhere in the SITC				5			4					4
Other (n.e.)		1	12			10	7					7
Total	**77**	**673**	**490**	**234**	**350**	**605**	**669**	**112**	**65**	**89**	**100**	**1128**

Source: Estevadeordal (1998).

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Floor Discussion of "Regional Integration Around the Pacific"

Political Commitment and Other Non-Economic Issues

While the economic aspects of regionalisation in Asia and Latin America ultimately received substantial attention from the conference participants, Barry Herman began a discussion of the non-economic aspects by suggesting a hypothesis. "It is worth noting that each of the panelists mentioned the importance of political organisations and institutions for regionalisation in the regions under discussion. While economic benefits and costs can be estimated and shared among participants, you cannot do the same with political benefits and costs. The latter are hard to measure because political dynamics are more complicated. Nonetheless, I would suggest that regional arrangements exist as long as there is a political glue to hold the arrangement together."

Stephany Griffith-Jones agreed with this and suggested that the European Commission's role in European integration could provide useful insight to Latin America. "Regardless of what one says about EC bureaucracy, it has played the role of keeping a vision of integration alive when individual countries have faltered."

Andrew Cornford asked Ricardo Ffrench-Davis for clarification regarding the benefits of preferential trade agreements (PTAs) in Latin America. "You seem to be saying that the PTAs in Latin America served as an enabling vehicle for constructing the necessary institutional infrastructure for trade between countries, and that without the PTAs, the infrastructure would not have been established because of political conflicts."

Ffrench-Davis confirmed this interpretation. "In Latin America, the institutional infrastructure and several other measures which helped to promote intra-regional trade were the result of the PTAs." Robert Devlin agreed. "Ricardo is absolutely right that the integration process induced thinking about the infrastructure that was not thought about before, and an example of this is Mercosur."

Arvind Panagariya, on the other hand, argued that a more convincing response with regard to the infrastructure issue would result from macroeconomic cost-benefit analysis. "If the issue is whether India should build a road to promote trade with Bangladesh or whether they should invest their resources in improving the port facilities which will hook it up better with the rest of the world – apply cost-benefit values to the two. If you think

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there is some extra value being generated in trade with Bangladesh or in trade with the rest of the world, you should add this to the benefit side. In my view, this should be the reasoning behind deciding what infrastructural projects should and should not be undertaken. There is really no need to attach infrastructural projects to PTAs. India and Bangladesh, for example, have completed their water-sharing agreements outside of the PTA."

Mohamed El-Erian wondered whether an external catalyst would be helpful. "It's clear that the amount of interaction in South Asia has been remarkably low, and that this has primarily been due to non-economic factors. In the case of the Middle East and North Africa, movement only started once they had the catalyst of the EU association agreements. Given the history of South Asia, are these countries able to move individually or would you need an outside catalyst?"

Pigato thought it unlikely that South Asia would be influenced by outside intervention. "I doubt India will accept anyone from the outside. And while India could perhaps play that role with the other countries, it has been less of a benevolent brother in the past – for obvious historical reasons. So I can't see any outsider playing that role."

Gavin Maasdorp turned the discussion to the peace dividend that might be gained from the South Asian Association for Regional Cooperation (SAARC). "I found Miria Pigato's statement about the peace dividend in SAARC interesting. If SAARC can establish itself as a highly stable free trade area, it would certainly be one of the building blocks for greater trade flows within the Indian Ocean rim. As a clarification, the Indian Ocean Rim Initiative is not envisaged as a free trade area but it is focused on regional cooperation."

Robert Devlin cautioned against relying too heavily on the peace dividend. "Increased trade and interdependence at the commercial level will not automatically guarantee peace. While it may be likely that increased interdependence and contact will reduce the risk of an outbreak of conflict, there are no guarantees." He then brought the discussion back to the issue of non-economic benefits. "Most of the regional integration agreements in Latin America, particularly Mercosur, are much more than PTAs. They are agreements in which the commitments go well beyond trade. In Mercosur, for instance, there is increased interdependence in trade and investment and there are projects to interlink universities. Mercosur has a common symbol which the public recognises. In fact, the polls show that the general public is behind bringing these countries together. So one has to go beyond economics and trade to see what is actually happening."

Percy Mistry stressed the importance of including non-economic issues in cost-benefit analysis. "Miria Pigato commented that a preferential trade agreement would be useful in Asia given the plethora of problems there.

This notion that there are non-economic gains from regionalisation raises an interesting issue: if the World Bank is willing to accept the price of preferential trade in order to get discussions started, what is the notional cost-benefit analysis that the Bank is undertaking in order to arrive at the conclusion that these losses from preferential trade are worth taking to achieve other benefits? What are these other benefits and why are you willing to make the trade-off?"

Miria Pigato answered by elaborating on the work done by the World Bank on South Asian countries' integration into the world economy. "When you look at South Asia, you face the fact that this is the poorest region in the world. There are 1.3 billion people and half a billion of them are living in poverty. This is also the most protected region in the world, and it is a region where political turmoil and governance issues are very present. We cannot really discuss development without taking these considerations into account. Twenty years ago, Sri Lanka was very open, and its level of human development was higher than any other country in the region – it could have been a miracle, but it is not. It has not developed as much as it could because of a 15-year civil war. All of the countries have now embarked on policies of opening up, and there is no turning back. This may ultimately result in a peace dividend."

Economic and Financial Issues

A discussion of the details of integration arrangements included issues such as the optimal level of tariffs, the effectiveness of regional financial arrangements and the appropriate macroeconomic policies of the countries involved. But first Salvatore Zecchini wondered about the type of integration emerging in Latin America. "It is not clear to me what kind of regionalism is developing in Latin America. Is this a regionalism that is just linked to tariff reduction and preferential trade arrangements or is it a regionalism that goes beyond tariff reductions into a real common market where enterprises from different countries can compete on a level playing field? You can reduce tariffs, but at the same time there are a number of other elements, such as taxation, which impinge on trade between countries. Are there any constraints on taxation, particularly indirect taxation, in these countries that have entered into the regional integration process?"

Robert Devlin answered that Latin American bilateral arrangements formally have the objective of a common market. He went on to say, "I think the only one which has a clear vision of where it is going is Mercosur. In the other arrangements, the declarations go far beyond the reality or the plans."

Stephany Griffith-Jones raised the issue of regional financial arrange-

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ments with a comment on Arvind Panagariya's presentation. "Most of your discussion was on trade, but in Asia finance has been and will remain a central issue. While the existing regional financial arrangements were initially strong enough to resist the currency crisis, they ultimately failed, and there is a lot of discussion about whether and how they should be upgraded. I think it would be interesting to include this issue in your analysis because there is a link between trade liberalisation and the willingness to create regional financial mechanisms."

Percy Mistry suggested that financial interrelationships were just as important in Latin America as in Asia and asked Robert Devlin and Ricardo Ffrench-Davis how they would construct regional financial arrangements in Latin America and whether they viewed them as an important step in the process of regionalisation, "especially considering the contagion effects of the debt crisis and the possibility of contagion effects of financial shocks emitted through global markets. How would these arrangements relate to national mechanisms and interlinkages with global defense mechanisms?"

Robert Devlin's impression was that in Latin America there was not too much activity with regard to financial arrangements. "Mercosur has, at this moment, no arrangements in the financial area. We are hoping to have a services protocol at the end of the year which will liberate financial services, but there are no larger financial arrangements to deal with surges in capital inflows or outflows. I think such arrangements are still quite far into the future because the countries are not even coordinating or exchanging information at the macro level. If it were to occur, it is likely to happen at the sub-regional level first."

Bertil Oden asked about the instruments for equalising the gains of regionalism. "As I understand it, for instance, this was a problem with the Andean Pact. Is this no longer a problem with the new type of regionalisation?"

Robert Devlin responded that this is still a worrisome issue in Latin America and that it could be traced to the 1960s and 1970s. "In this period, almost all of the schemes had compensatory mechanisms for the least developed countries. What ultimately happened, however, is that the mechanisms became permanent. There was no convergence or effort at convergence in the laggard countries, and this has created some resentment among the more advanced countries. As a result, the style of integration today is that everyone enters almost immediately on equal terms. This could be a shortcoming because we know that in all of these types of agreements there are asymmetric distributions which can become severe and undermine the whole integration process."

Salvatore Zecchini made three observations regarding foreign direct investment (FDI) and trade in Latin America. "It is believed that a substantial portion of trade expansion in today's markets is linked to FDI – exports of goods with exports of capital. In this respect, what is the evidence as far as Latin America is concerned? Second, is there any move to couple trade agreements with agreements to protect or promote FDI? My third point has to do with the commodity composition of trade once these countries enter into a preferential trade agreement. Is there a tendency toward trade specialisation in Latin America which would justify this move toward preferential trade agreements or is there an evolution toward intra-industry trade? If it is the latter, it invalidates the argument that you join a free trade area because you have complementarities in productions structures. I would be interested in knowing more about the evidence and conclusions in order to better characterise Latin American regionalism."

Following up on Zecchini's observations, Arvind Panagariya argued, "If you want to harmonise your investment policies, you don't necessarily have to attach it to a PTA. Many of the investment agreements are bilateral treaties, so if you really want to proceed on that front, you could do so without a regional arrangement."

Robert Devlin concluded the discussion by commenting on the issue of tariff and non-tariff barriers. "Regional integration arrangements tend to be second- or third-best strategic compromises to bring countries together that might not otherwise cooperate. But regardless of the external levels of protection specified in the agreement, it is important to reduce protection over time. This will erode preferences and insure that firms are eventually put to the test of the global market. It is certainly true that many arrangements, including Mercosur, include non-tariff measures which restrict trade. These are usually technical measures such as rules of origin, but these should be eased over time – presumably as the competitive position of the firm and the country improves. I see this as part of an evolution. In Mercosur, non-tariff barriers are the primary obstacle and there is a major project to eliminate these barriers between 1998 and 2000."

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Part IV

Africa and the Middle East

The Prospects and Priorities of Regional Integration in Sub-Saharan Africa

Ernest Aryeetey

I Introduction

For many years, regional integration[1] has been regarded by Sub-Saharan African (SSA) policymakers to be a highly desirable objective. This remains so, despite the lack of decisive and concrete actions to achieve integration. There have been many arguments in support of integration at regional meetings and relatively few against. As a consequence, institutions and protocols for regional integration are available in relative abundance. The integration discussions and efforts in SSA have covered such varied areas as trade integration, labour market integration, capital market integration, monetary integration, etc. Trade integration has naturally attracted greater attention from policymakers[2] and also researchers, and this will be reflected in our initial discussion here, even though the priorities discussed later emphasise other areas of integration.

The intuitive appeal for regional integration is drawn from the smallness of SSA economies and the belief that 'there is comfort in numbers'. The size of the SSA economy has been compared to that of Belgium, a small European economy by Foroutan (1993). Managing such a small economy with over 40 separate governmental and other institutional arrangements is almost certainly less efficient than running the Belgian economy. In this light, regional integration units have traditionally been perceived as vehicles for making SSA economies overcome the constraint of small economic size which has hampered their ability to industrialise efficiently, particularly within the context of the import-substitution industrialisation path they adopted prior to the reforms of the last decade.

While the appeal for integration has remained strong for several decades there are differences in the perception today of how integration should be

1 The expression 'regional integration' is used throughout this paper to cover the full range of public sector activities that involve permanent collaborative ventures, including economic policy, regional security, human rights, education, health, research technology, and natural resource management. Regional integration is generally characterised by the establishment of joint institutional mechanisms and a degree of shared sovereignty.

2 While the number of institutions for promoting and managing integration (particularly trade integration) have grown, intra-regional trade has remained low, and for some countries, actually declined in the last decade.

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conceived and pursued. After a lull in the discussions in the 1980s, there has been a resurgence of academic interest in the subject (Lavergne, 1997). The domination of trade creation in the discussions is amply reflected in the types of arguments often advanced. A number of scholars continue to argue that SSA regional groupings are unlikely to confer net positive static welfare gains on members because they do not have the required conditions to enable their trade creation effects outweigh trade diversion effects (Jebuni, 1997). They therefore argue for a more cautious approach of generalising the removal of tariffs and other barriers to trade. They generally believe that the Asian experience may be relevant; hence formal integration efforts should be abandoned and policymakers concentrate on developing an outward-oriented trade policy which encourages trade and which eventually may result in greater trade integration (Husain, 1992; Jebuni, 1997).

A contrary view is that formal regional integration is imperative for SSA economies. In the present world economy with large trading blocs, SSA needs to be able to attract foreign investment and technology necessary for investment. "Regional integration may be the most practicable way to minimise the costs of African market fragmentation ... It may thus be a precondition for rather than an obstacle to integrating SSA more effectively with the world economy" (Robson, 1993: 341). It is sometimes argued that regardless of the fact of low net gains from trade integration and the institutions that pursue them, the regional groupings and their institutions are essential for making SSA respond to increasing global marginalisation (Onitiri, 1997).

I shall discuss initially in this paper some of the arguments covered in the broad spectrum of integration policy recommendations circulating in SSA, highlighting those that have tended to dominate the debate and are likely to influence to some extent future courses of action. This will be followed by a discussion of some of the more recent attempts to introduce other dimensions of integration, in particular those that go beyond the traditional arguments of trade creation. Here, I pay some attention to interest in integrating financial markets.

II Old and New Debates on Regional Integration in Sub-Saharan Africa

The current context within which SSA governments are taking a look at regional integration differs from that of the past. Since import substitution is no longer the driving force behind integration, most countries are currently pursuing economic reforms that have a strong trade liberalisation component. Indeed, the need to derive more benefits from the liberalisa-

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tion efforts is increasingly being pushed forward as a reason for pursuing integration, while pressure to avoid marginalisation has considerable political appeal. In addition to these, the fact that SSA has been by-passed in the last wave of investment flows to emerging markets has led to considerable soul-searching among SSA policymakers and researchers. Important regional groupings amongst the industrialised countries, particularly NAFTA and the new EU, have also stimulated new efforts towards regional integration. I focus below on the two polar strategies of unilateral liberalisation of trade on a non-preferential basis on the one hand, and the promotion of a pan-African economic union that has a centralised decision structure to coordinate reciprocal preferential policies on the other. This is followed by a discussion of some intermediate positions that embrace a number of other considerations being discussed by African academics.

Unilateral Non-Preferential Trade Liberalisation

As pointed out earlier, Husain (1992) has recommended a focus on unilateral trade liberalisation. Jebuni (1997) takes the case a little further as he comes out strongly in favour of unilateral non-preferential trade liberalisation after questioning "whether inward-looking preferential liberalisation can increase intra-African trade". After observing a high level of protection that has been provided to import-substitution industries, he suggests that so long as protection remains alongside import-substitution strategies, preferential trade liberalisation will be meaningless. This is because preferential trade liberalisation does not provide any incentive for firms to export when there is high protection for import-substitution firms. Indeed the high tariffs placed on imports affect exports in a significant way in many countries

The arguments of Jebuni (1997) rest on the non-recognition of significant positive outcomes from macroeconomic reform in various countries and the little change in domestic policies even when pursuing preferential trade liberalisation. The argument against regional groupings rests mainly on the diversionary effects of preferential tariffs. But those effects remain high because of the relatively high SSA tariffs. "At present, despite considerable reductions in trade barriers over the past decade, most African countries impose fairly high barriers through tariffs and export taxes or through managed exchange rate arrangements" (Oyejide, *et al.*, 1997: 16). Jebuni (1997) observes that, given that manufactures dominate intra-African exports presently, the potential for expanded exports of manufactures and other non-traditional exports exists, but these are hurt unnecessarily by national protective measures. Countries will therefore have to unilaterally bring down tariffs in a general manner in order to establish a

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basic incentive for the growth of exports. SSA trade integration will then take place as an off-shoot of the process of lowering tariffs unilaterally. Jebuni suggests that since tariffs came down somewhat in the last decade through unilateral non-preferential arrangements, SSA's intra-regional trade has expanded more rapidly than its other international trade, even if still slow.

The arguments against this approach are that countries will be pursuing their policy objectives at different speeds, which will inevitably lead to a widening of the disparities in tariff structures and hence discourage intra-regional trade as the task of harmonisation becomes more difficult. On the surface, the promotion of unilateral non-preferential trade liberalisation would appear to be in conflict with the formation of a regional preferential trade area; for, as Oyejide *et al.* (1997) point out, the lower the tariffs, the less opportunity a country has to offer a preferential tariff. On the other hand, as suggested by Fine and Yeo (1997), lower tariffs reduce the costs of trade diversion that will be observed from a preferential trade area.

Even though many SSA governments have pledged to work towards the reduction of tariffs unilaterally as they pursue reforms, the pace continues to be slow and there does not appear to be much prospect in sight for faster action. A major obstacle is the likely loss of tax revenue in the short run, which makes a unilateral tariff reduction appear tantamount to shooting oneself in the foot. I turn now to the other extreme end before looking at intermediate positions.

Pan-African Economic Union

One of the most recent restatements of the need for a pan-African economic union has been by Onitiri (1997). He argues that if SSA is to avoid being marginalised following the 'revolution' in the international economy, it must enhance productivity, a process that requires more than simple trade integration. He says this requires full economic integration. As McCarthy (1996) has pointed out, historically, full economic integration can be achieved through a step-wise graduation of integration units. They may start with economic cooperation, for example, for the purpose of running a joint regional airline or a coordinated rail system. This may be followed by a more narrowly focused trade integration beginning with a free trade area and progressively reaching into customs union, then a common market.[3] Finally, they may have an economic union when they start pursuing common fiscal and monetary policies.

3 When capital and labour join goods and non-factor services in the free flow among member states.

Onitiri's (1997) view of integration is as embodied in the Treaty of the African Economic Community (AEC) assuming that all the intermediate steps have been taken already in the years of experimenting with one grouping or another. For this, 'variable geometry' is at variance with the AEC Treaty. The AEC is conceived as the means for providing "an effective response to the prevalence of regional economic blocs" all over the world. Onitiri (1997) observes that, "Since the Treaty embraces all aspects of African economic and social life, it also provides a convenient framework for re-examining and streamlining the activities of the existing African international government organisations and mobilising them more effectively to address the pressing problems of African economic and social development" (Onitiri, 1997: 417).

The AEC will move beyond trade integration into the integration of production, the harmonisation of fiscal and monetary policies, as well as into conflict resolution and the coordination of policies on the environment. It is proposed under the AEC Treaty, in addition to the large number of implementing mechanisms, to delegate the task of administering and managing the community to a single OAU/AEC secretariat. The restructuring of the present Organisation for African Unity (OAU) to play the new role assigned to it suggests that it will have an enlarged bureaucracy, a proposal which seems to frighten many African intellectuals (Oyejide *et al.*, 1997). It will be running the show in concert with the African Development Bank (AfDB) and the Economic Commission for Africa (ECA).

The concept of the AEC supported by Onitiri has been treated differently by Mistry (1995), who, with an incremental approach, has suggested the adoption of sectoral investment coordination and cooperation, trade integration and the development of an appropriate institutional framework. In Mistry's view, a regional policy environment must be created to allow the gradual integration of markets. This approach differs from the practice of current regional agreements where emphasis is placed on trade integration without addressing adequately the infrastructural and institutional framework which is necessary to facilitate the trade integration process. Rather than dismissing variable geometry, Mistry proposes the adoption of a core group willing to implement a customs union and the existence of "a wider group at the periphery which might constitute itself as a free trade area, and be linked with the former in a free trade agreement ..." (Mistry, 1995: 42).

Arguments that may be pushed forward against the idea of the AEC include the fact that many of the expected benefits do not require preferential tariffs in order to be realised (Oyejide *et al.*, 1997). It is also suggested that in the past, coordination of activities that brought net gains to all participating countries (such as joint infrastructures) was impeded by tying

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their negotiations to trade policies where the gains were not that transparent and discouraged potential losers.

Obviously, for many SSA policymakers, the situation is not one of an either/or choice. Some of the benefits expected under either unilateral non-preferential trade liberalisation or an economic union with preferential tariff arrangements could be attained without necessarily choosing one approach. This is what has encouraged the development of intermediate approaches.

Intermediate Approaches to Regional Integration

Foroutan (1993) accepts the principle of integration but proposes that the trade integration approach be avoided. This view is shared by Langhammer and Hiemenz (1991). They do not consider trade and factor integration feasible because of the dissimilarity of African economies and the difficulties of putting in place an effective compensation mechanism (Foroutan, 1993). What is considered to be essential are cooperation, coordination and harmonisation. Like many others, they emphasise the provision of infrastructural facilities, training and research. The advantage of regional cooperation in infrastructure investment is that all members benefit irrespective of their size and level of economic development thus avoiding the problem of compensation (Robinson, 1996).

Another proposal for enhanced regional integration in Africa is to enter into a union with the European Union, very much after NAFTA (Fine and Yeo, 1997; Collier and Gunning, 1995). A number of advantages are expected to come from such a union. Collier and Gunning (1995) argue that forming an integration unit with the North will generate all the gains from global liberalisation. Also, such a union would enhance the credibility of African trade liberalisation and generate the desired investment inflows. This is because integration with the North would be an effective 'lock-in arrangement'. The possible loss of access to European markets may be an effective means of binding governments to a particular line of action.

The proposal for a North-South integration does not address the issue of distribution of gains. One clearly cannot assume that guaranteed access to EU markets is adequate compensation for the revenue loss accompanying regional trade liberalisation. Since the EU is the largest trading partner for most SSA countries, duty free entry of EU goods will definitely have a negative impact on trade revenues, and possible negative implications for total revenues in the short run. This might be remedied with aid to finance compensatory schemes and support regional infrastructural and industrial projects.

Another difficulty with North-South integration at this stage of Africa's

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development is that it runs counter to the spirit of self-reliance which has considerable influenced the goal of integration. This lies at the bottom of the revised ECOWAS Treaty and the Lagos Plan of Action. Evidence of how it will be resisted, particularly by SSA regional bureaucrats is provided in the comments by Asante (1996) on the subject. The problem of self-reliance will not be an intractable one, however, if the formation of such a union increases the ability of SSA economies to respond to shocks without external assistance and helps them to diversify their production structures and exports. This is a good reason why a number of regional observers are looking for possible pointers from the UEMOA (West African Economic and Monetary Union) experience.

III New Priorities for Regional Integration in Africa

SSA's problems are wide-ranging. The continent has suffered from prolonged economic and social crises. The state in many countries suffers from loss of credibility, which affects its ability to mobilise resources in order to counter the mounting problems. The growing debt burden pushes governments to support their economies increasingly with aid, in magnitudes that are clearly unsustainable. There are indeed countries such as Tanzania and Senegal, that have aid levels of more than 20 percent of GDP. It is becoming increasingly evident that the institutions of the small countries will have considerable difficulty dealing with these problems on their own. The need to turn to supra-national structures and institutions in order to provide the state with some credibility, and make possible additional resources is becoming more and more urgent.

Current discussions of regional integration "reflect a general desire to break the confines of the nation-state ... including the multiple barriers to the free movement of goods and services, people, and capital among countries, and differences in legal, governmental, and educational structures" (Lavergne, 1997: 3). The growing scope of regional integration is derived partly from the new role of the private sector in various countries. The private sector wishes to see the removal of all impediments to a greater participation in the economic activities of the entire region, as market size continues to shrink within countries. Stronger and more effective supranational bodies that share sovereignty with governments are needed to achieve credibility with the private sector.

While it is obvious that SSA needs to grow as rapidly as possible, this would require considerable investments from both within SSA and from outside. Enhanced trade is an essential requirement for this growth to occur, as well as other fundamental economic undertakings to make good use of the investments. Some form of integration may harness the resources that individual countries cannot gain access to. The continent's integration needs to go far beyond trade creation. Its immediate task is to attract as much investment as possible and use it efficiently for both production and exchange.

In order to do this the regional policy choice for SSA countries is not necessarily a choice between one bipolar position and the other; i.e. unilateral non-preferential trade liberalisation versus an all-embracing pan-African economic union. It is more a question of how competently they can use any institutional framework to attract the required investments and stimulate a rational distribution of these across countries. If they have not attracted investments after trade liberalisation and other reforms it is partly because the reforms have not been deemed to be credible. Will any kind of lock-in arrangement provide that kind of credibility? Does SSA need a union with the EU? Can the AEC provide policy credibility? Can individual countries guarantee adequate trade reforms and establish credible industrial development programmes? Should the discussion of regional integration move beyond the economic variables? These are all empirical questions requiring more detailed study. It is obvious, however that, while most unilateral trade policy reform attempts continue to lack credibility for the fear of reversals, a pan-African economic union seems also to be too far-fetched to become the major instrument for attracting the required investments. In the end, the choice will be made not only on rational economic grounds, hut influenced considerably by politics and diplomacy.

On the side of politics and diplomacy, we need to note that SSA countries have already expressed a commitment to establishing the African Economic Community, and it is unlikely that this commitment will diminish soon. The most rational thing to do, therefore, is to ensure that the AEC does what is necessary in order to attract the required investments. It is essential that the AEC will not be perceived as just another regional institution whose existence only marginally affects the economic policies and decisions that various countries and their economic agents make. The priorities I discuss below are issues that the AEC must deal with immediately in order for SSA regional integration to become an effective development strategy. They include:

- developing appropriate macroeconomic frameworks to facilitate greater interaction among the resources of countries;
- establishing mechanisms for attracting both private and public capital flows from the rest of the world;
- establishing and publicising the fact that there are gains to be made from cooperation in investment in infrastructure and market integration,

indicating clearly the opportunity costs of not cooperating;
- fashioning out an appropriate industrial development policy;
- developing an effective compensatory mechanism to ensure that all countries will receive some of the gains from increased trade;
- developing institutional frameworks for the better management of the region's resources including human resources;
- rationalising (sub-)regional arrangements to reduce replication of efforts and conflicts. In rationalising these existing arrangements, it is essential that the rest of the world sees SSA as speaking with a common voice for a clear purpose in order to strengthen its position vis-à-vis the other regions.

Macroeconomic Reforms to Facilitate Integration

Many countries pursuing integration within the arrangements of existing regional groupings often have different macroeconomic situations that serve as entry points. They generally suffer from macroeconomic instability and are pursuing economic reforms of different intensities. Mistry (1996) has suggested that the considerable variation in intensity, sequencing, scope, etc. has a significant negative impact on the outcomes of both the reform process and on the objective of regional cooperation and integration.

In West Africa, Badiane (1997) has observed that trade liberalisation yielded far less positive outcomes than expected because macroeconomic policy reforms were not uniformly pursued. One aberration was that while the CFA remained overvalued for over a decade, the 1994 devaluation occurred at the same time that Nigeria was revaluing the Naira by a similar margin. Similarly, the Ghanaian Cedi was appreciating in real terms as the CFA was devalued. The lack of synergy in these policy developments harmed the ability to generate substantial benefits from both trade reforms and macroeconomic reforms. Well-tuned and synchronised macroeconomic reforms are far more likely to generate net gains than preferential trading arrangements.

What this means is that, for sustainable macroeconomic reforms, neighbouring countries must share similar visions that lead to the introduction of similar or complementary policies particularly with respect to exchange rates, fiscal policy and monetary policy. The harmonisation of these policies is probably more crucial than trade reforms in the creation of trade. In the absence of such an approach to reforms, the bad policies of neighbouring economies affect performance in other countries. Mistry (1996) showed how unstable situations or destabilising activities in neighbouring countries affect others. There is the example of how Zambia's open capital account is used as a convenient route for illicit transactions with South African entrepreneurs to arrange capital flight from Zambia (as South African-made goods are exchanged for US dollars available on the open market). In West Africa, Ghana blamed the instability in its foreign exchange market on Ivorian and Nigerian speculators who obtained unhindered access to the liberalised foreign exchange market, to meet a demand that could not be met in their countries with over-valued currencies.

Regional Integration and Private Capital Flows

Private capital flows, particularly foreign direct investment and portfolio equity, into the developing world grew remarkably after the mid-1980s. Their share in total private flows moved to an average 35% and 13.5% respectively in the period 1990-1996, up from 12% and 1.2% a decade earlier. The growth is generally attributed to the growing integration of markets and financial institutions, increased economic liberalisation and rapid innovation in financial instruments and technologies, particularly in the areas of computing and telecommunications. For SSA, however, most of these growing flows were hardly observed as they were directed at Asia and Latin America. China alone accounted for 86% of total FDI flows in 1995. Even though Nigeria is the second largest recipient of FDI, this is not diversified and mainly restricted to the extractive sector of the economy as is the case in Ghana.

Thus, SSA currently attracts only 4% of the emerging markets portfolio, which is itself only a small proportion of global capital flows. Despite this low magnitude, it is considered that SSA has a significant chance of becoming a major drawer of capital and investments for a number of reasons (Senbet, 1997). The reasons include the fact that in the last couple of years, the number of operating capital markets in Africa has grown considerably reaching 16 at the beginning of this year, up from less than five a decade ago. Moreover, African markets have in the last few years begun to attract international attention. Thus over a dozen African investment funds have been established since 1993, trading in Europe and New York. These African funds had a total investment of $1 billion at the beginning of 1997, up from zero in 1992.

Based on these achievements of the last few years, SSA is increasingly viewed as being capable of attracting more private capital, if only it will put its house in order (Senbet, 1997). With increasing and more effective financial sector reforms, the way should be paved for increased flows as global investors look for new frontier markets. Since emerging markets are under-represented in the global market, it is expected that they will increase their share. With improved infrastructure and policies, SSA should enhance its ability to become an important player, as international investors seek out the last frontier.

Senbet (1997) has proposed a number of developments that should take place in SSA economies in order for them to be considered as serious players. These include: the development of public confidence and informational efficiency; the promotion of financial market integration through regionalisation; the development of human resources and infrastructure; the promotion of capital market development through privatisation; the globalisation of SSA financial markets; the fostering of financial innovation and the use of informal sector signals; the design of efficient regulatory systems; and a solution to the negative perceptions on risk in SSA.

Quite a number of the financial sector reforms that SSA saw in the last decade are attempting to tackle many of these issues What still remains untouched by the reforms is the issue of globalisation and regionalisation of the market and the regulatory issues associated with this. With the stock markets generally considered to be thin, the pooling of resources as well as the harmonisation of the securities and investment laws should enhance competition among countries in the region and enhance public confidence in the markets. The likely effect of this will be a considerable growth in cross-listing of securities. There is only very little of that happening now, as in the case of Namibia and Zimbabwe and also for Ashanti Goldfields in Ghana and Zimbabwe.

The development of a regional stock exchange which is centred around the exchange in Abidjan is currently under serious consideration by the francophone West African countries. The stock exchange operators of Ghana are also considering ways of cooperating with such a regional exchange. There are also a number of proposals for developing stronger linkages between the Johannesburg exchange and the smaller exchanges of Botswana, Namibia, Swaziland and Zimbabwe for Southern Africa (Jefferis, *et al.*, 1997). One of the burning issues that has to be tackled is the issue of regulation of a regional stock exchange.

In the absence of regional stock exchanges and their regulatory bodies, a lot of financial transactions inevitably must be handled by central banks and the rest of the banking system. Hence, the integration of financial markets across country borders is seen as the major key to the dilemma (Folkerts-Landau and Van Greuning, 1997). A number of SSA countries with more internationally-oriented emerging financial markets have become interested in strengthening monetary cooperation and financial market infrastructure. The Franc zone allows countries to share a common currency with a common central bank. They are moving steadily towards modernising bank regulation, liberalising markets, improving supervision and moving towards indirect monetary instruments at the regional level.

They are continuing to develop regional bond and equity markets as well as regional pension and insurance regulations.

The argument for integrating financial market infrastructure in SSA is based on the notion that "prudent cross-border lending and investment can diversify financial institutions' asset risks away from the small number of economic sectors that dominate so many national economies and that are prone to frequent shocks" (Folkerts-Landau and Van Greuning, 1997: 1) In Southern Africa, for example, it is argued that the concentration of economic activity in a small number of natural resources, e.g. tobacco in Malawi, cattle and diamonds in Botswana, copper in Zambia, ensures that banks are often largely exposed to only a few industries and crops. They can diversify their asset portfolios by investing abroad, a step which helps them to reduce their exposure to risk while increasing the volume of inflation-adjusted lending.

Further arguments for regionalisation of banking is that the new legislation and regulations from an outside body act as an agency of restraint on national authorities when banking regulations have been harmonised. This allows for coordinated supervision. Further benefits come from the possibility of averaging country resources to mitigate small country concerns and the possibility of a coordinated response to financial crisis as happened with the problems created by the Meridien Bank failure.[4] Folkerts-Landau and Van Greuning (1997) provide many other reasons why such integration would improve the service delivery and efficiency of financial institutions in SSA.

The main approach recommended for integration is the institution of a regional supervising authority, which might be either private or public, charged with responsibility for off-site analysis of adherence to prudential rules and regulations on a regional basis. Such off-site supervision which will entail processing returns and manipulating data will lead to evaluating and interpreting individual banks risk management processes as well as their performance. The supervisory authority will need to be well-equipped with appropriate standards and regulations, as well as human capacity in order to establish its credibility.

4 Meridien BIAO was an international banking group with the umbrella bank based in Luxembourg and its treasury based in the Bahamas. It started operations in a number of African countries in the mid-1980s as countries began reforms. The parent bank in Luxembourg held 75% of total shares of the group, while the Bahamas often held up to 55% of the shares of Meridien BIAO in various countries. Meridien BIAO became exposed (deposit-wise) to the Bahamas in a significant way. When the Bahamas, being the treasury of the group, suffered severe over-exposure on its assets, this triggered a chain of financial distress within the group, affecting the banks in Ghana, Nigeria, Swaziland and Zambia.

Cooperation in Infrastructure Development

A major obstacle to the implementation of the Economic Commission for Africa's sub-regional plan for Africa's industrialisation were the deficiencies in physical (transport and communications) and institutional (commodity exchanges, clearing houses, etc.) infrastructure. Cooperation in the provision of regional economic infrastructure is bound to facilitate market integration and reduce transaction costs, facilitating greater trade integration, as well as encouraging more regional investment. Even though some arrangements exist with current sub-regional arrangements for the purpose of developing regional infrastructure, these have had very little impact. For example, the ECOWAS Fund for Cooperation, Compensation and Development was established and located in Lomé in 1977 with the objective of promoting economic development and integration through the financing of industrial and infrastructure projects of common interest to ECOWAS states.

Robinson (1996) noted that "despite its 'win-win' characteristics, the level of regional cooperation in infrastructure and natural resources in the past has been disappointingly low." In the area of energy supply, there are very few intra-regional supply arrangements, even though the potential for intra-regional grid connections exist at non-prohibitive costs. The potential exists to cooperate in the areas of water and transport with benefits for all parties involved. Sarfoh (1993) has indicated that the gross potential hydro-electricity that can be generated by SSA's large water resources has been estimated at 300 gigawatts, out of which only 4% has been exploited.

The potential gains from regional cooperation in infrastructure and natural resource development are reflected in the way they contribute to economic growth. The first channel is the direct cost reductions that can be achieved for both capital and operating costs, via economies of scale. Another channel is the reduced opportunity costs for unserved demand. Robinson (1996) argues that "in situations where, for example, investment is inhibited by lack of access to electricity, water, transport or telecommunications facilities, the opportunity cost associated with unmet demand can be very high" (p. 71). It is also argued that supply can be enhanced through the operation of conjunctive systems. An example of this is the cooperation in the supply of energy between Ghana and Côte d'Ivoire which allows each country to complement the other's supply in times of shortage.

Other gains expected from joint infrastructural development are a positive impact on trade as well as the likely savings when investments are lumpy. Robinson (1996) also expects some dynamic gains to be achieved. "Dynamic gains are also likely to accrue from regional cooperation in infrastructure. In infrastructural systems which operate more efficiently as a result of regional cooperation, technological and managerial skills are acquired by the nationals of the countries involved, and these will spread into other activities in the same sector, or into other sectors contributing to progressive efficiency gains. Foreign investors participating in regional projects are also more likely to participate in member countries when they have acquired some experience and familiarity with the region" (p.75).

One way in which SSA can effectively achieve an integrated provision of infrastructure is to negotiate together a change in the composition of aid from the industrialised world. I have argued that 70 percent of multilateral project assistance should be directed at developing regional infrastructure, focusing on transport and communications, energy and water development (Aryeetey and Oduro, 1996). This would be adequate for starting the process of building a sound infrastructure base.

Industrial Policy

Most SSA countries have a small manufacturing base with little or no inter-industry linkages. Several years after the creation of SSA regional units, they remain unable to generate substantial increases in intra-African trade in manufactures. Mistry (1996) has suggested that the emphasis on trade integration within the current integration arrangements of SSA without a regional policy for the production base may explain why the benefits of regional integration efforts have been limited. The small manufacturing base in SSA requires that trade integration should be accompanied by production integration to develop that manufacturing base.

There is often a tendency, particularly under proposals for general trade liberalisation, to let trade policy subsume industrial policy. The response of the industrial sector under any liberalisation scheme cannot be taken for granted since that response is also dependent on other factors aside from trade policy including the macroeconomic conditions. The problems that arise from these must be addressed with an appropriate set of regional industrial policies.

Industrial policy should, however not be seen as a simple collection of policies for intervening in the functioning of markets, as was the case in the early post-independence period. Industrial policy should be conceived as a tool for assisting markets to function more efficiently. This point is made considering the fact that under reforms, the principles of trade liberalisation and 'getting prices right' were relied on to ensure that industry and other sectors could produce in an assumed efficient way, in order to pave the way for an almost self-operating or automated process of development. Inadequate attention was paid to the second-best consideration that trade and market liberalisation may not increase efficiency when

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some markets (such as insurance and credit markets) cannot be made to function perfectly (in practice this is never possible), either as a consequence of more conventional types of market failure or for reasons related to the cost of transactions and lack of perfect information. Also, little importance was attached to the fact that even if static efficiency gains were realised by moving the economy onto the production frontier, this in no way implied that the frontier would subsequently shift outwards in a dynamic way.

Hence harmonised industrial policies would encompass any set of policies that remove structural and institutional bottlenecks to the development of industry, particularly across national frontiers, without the state's direct involvement. This is when the private sector's role in fashioning integration becomes most desirable.[5] Industrial policies complement the development of suitable infrastructure and ensure that institutions work.

Effective Compensatory Mechanism

A major obstacle to galvanising the political will to lower import tariffs is the likely loss of revenue. Compensatory schemes that have been established for the purpose of minimising this problem have had little impact. McCarthy (1996) has suggested that the issue of compensation and the failure of the compensation mechanism to address those concerns was important in explaining the collapse of the East African Community. For ECOWAS, the Trade Liberalisation Scheme Compensation Fund which was set up in 1990 to compensate member states for losses in revenue arising from the introduction of trade liberalisation measures, is observed to have had little impact in allaying the fears of member states (Aryeetey and Oduro, 1996).

But the experience of Ghana, for example, shows that there can be reduced dependence on trade taxes as a source of revenue (without total revenues declining) within the context of unilateral trade liberalisation supported by compensating exchange rate adjustments and tax reform measures which tap the potential tax base more effectively. It may be deduced from this that regional trade liberalisation need not necessarily result in a decline in total revenues. What is essential for the AEC to do in that case, is to ensure that the overall level of trade protection is reduced so that the revenue losses of countries are minimised following unilateral trade liberalisation by members.

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5 The absence of active involvement of the private sector in the formulation of decisions, protocols, etc. on regional integration is largely because at the time the agreements were ratified, most of the regimes were statist in outlook. Domestic economic policy did not actively encourage private enterprise.

Cooperation in International Negotiations

Formation of a regional unit can increase the bargaining strength of the member countries. This requires an ability to adopt a unified regional position on the relevant issues. This is particularly important for negotiating trade and international commodity agreements with third parties. A prerequisite for this, however, is the coordination of national agricultural and industrial policies. It may be possible to obtain more trade concessions *en bloc* as opposed to individually. In this case, SSA countries may be more willing to drop the principle of non-reciprocity in their trade negotiations since they will be negotiating from a stronger position.

A clear test of the willingness of SSA countries to jointly negotiate for concessions will be when the Uruguay Round comes up for re-negotiation. Sorsa (1997) shows that SSA did not use the Uruguay Round to support domestic efforts at trade policy reform. They did not seek to place on the table for discussion such pertinent issues as agricultural taxation whereas the agricultural subsidies of concern to the industrialised nations were a major item on the agenda. When the Uruguay Round created opportunities for binding tariffs to newly liberalised rates, most SSA countries did not take advantage of the opportunity. The round would have provided them with an opportunity to lock their unilateral trade policy reforms into an international framework that would provide the needed credibility for foreign investment by making policy easily predictable and stable. Coordinated negotiation would allow the countries to force on the agenda the issues of relevance to the region, and the AEC must take this up.

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The SADC Trade Protocol and the Enabling Clause: A View from South Africa

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I Introduction

At the Maseru Summit in August 1996, member states of the Southern African Development Community (SADC) adopted a Trade and Development Protocol which is an "interim arrangement" leading to the establishment of a free-trade area (FTA) within 8 years. This Protocol conforms to a symmetrical GATT Article XXIV free-trade agreement – and herein lies the problem. By its very symmetrical design, the Protocol treats all SADC states as 'equal', and requires them to uniformly follow through on obligations to *inter alia*, reduce tariffs, harmonise on standards and policies and phase out subsidies and non-tariff barriers to trade. While such uniform application of contractual liability is legally and politically correct since they are sovereign member states entering into treaty obligations, it creates an absurdity when analysed from an economic perspective. What the Protocol should have done was to introduce the concept of differentiation by building in temporary compensating asymmetries in order to account for the diversity in the size and strength of the various economies of SADC countries.

To their credit, member states have recognised that the Protocol is a framework agreement, and have accepted that some flexibility is needed in negotiating the necessary commitments. The written agreement, however, makes no provision for such flexibility, and therefore everything rests on the negotiators in the Trade Negotiating Forum who must move the process forward in a way that has real meaning for each country. This paper analyses the SADC Trade Protocol from a South African perspective. It

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examines its importance for South Africa and includes current thinking on how the protocol should evolve and how it should relate to the WTO Regime. In this context, the paper will also touch on South Africa's classification at the WTO as a 'developed' economy.

II Historical Background

The first draft Protocol tabled in 1994, suggested that the FTA would be established immediately upon its entry into force. This draft took a neo-classical approach to trade liberalisation. At no stage did it mention development or industrialisation. Indeed, proponents of the earlier draft did not see the importance of the link between trade and industrial policies.

After South Africa's accession to the SADC Treaty in August 1994, it expressed concern about the appropriateness of the draft Protocol for the region, especially the desire to move immediately to an FTA without considering the diversity between SADC member states. In June 1995, South Africa supported its arguments with the results of a preliminary study carried out by the South African Industrial Development Corporation which showed that an FTA would have immediate economic benefits only for South Africa and would result in de-industrialisation in the rest of the region. It was already evident that some countries in the region (Zambia, Tanzania, Malawi and Zimbabwe in particular) were experiencing stagnation in industrial output and exports, very little diversification and a significant amount of dislocation and de-industrialisation, i.e these economies had largely become 'sellers' markets'. Under structural adjustment programmes (SAPs) and within the confines of the Cross-Border Initiative (CBI), these states had already liberalised unilaterally (globally or within the Common Market for Eastern and Southern Africa – COMESA). Because of its more open economy, Zambian trade with South Africa was ballooning, exacerbating its trade deficit and causing de-industrialisation.[2]

South Africa called for a joint SADC study to analyse the impact of a free trade regime on Southern Africa. South Africa was willing to consider an arrangement of asymmetrical trade in SADC which disadvantaged South Africa in favour of the others. It would lower its tariff regime for imports from its SADC partners at a faster rate than they would be required to do for South Africa.

2 Several economists had commented upon the IMF/WBGs SAPs, alerting policymakers to the inherent dangers if the specificities of the individual countries and the sequencing of events were not considered. See, e.g. M. Shafaeddin (1995); Ajit Singh (1994); and G.K. Helleiner (1986).

In January 1996, the SITC (Standard International Trade Classification) delegates met with SADC delegates during the Annual Consultative Conference in Johannesburg. With bilateral trade tensions having reached unprecedentedly high levels,[3] they decided to create a Trade Negotiating Forum (TNF) to deal with both regional and bilateral negotiations. The TNF is now adopted in the Protocol as the main institutional framework within which trade negotiations will take place. In May 1996, the TNF met for the first time in Dar-es-Salaam to consider both its own terms of reference and the new revised draft agreement. Facing a tight schedule and unfinished business, they met once again in June 1996 in Pretoria. It was evident at the June meeting that considerable differences still existed on the revised Protocol. A further meeting took place in Dar-es-Salaam in August 1996. The parties reached agreement on an 8-year time frame for the FTA, the domestic content in the Rules of Origin (35 percent *ad valorem*, to apply cumulatively),[4] and a one-year time limit to arrive at proposals on sensitive items, especially textiles and agricultural products. Described as a "framework agreement", the Protocol was adopted by heads of state in Maseru in August, 1996.

III Political Sovereignty versus Economic Reality

The Trade Protocol manifests the type of contradictions that are emerging in the 1990s with regard to statehood, international law and interdependency, i.e. a contradiction between the accepted, universally applied doctrine of the 'sovereign equality of States' found in general public international law and the continuous dilution of the same doctrine in the field of international economic law. Writing on this subject, Thomas M. Franck has opined, "Sovereignty has historically been a factor greatly overrated in

3 Both Zambia and Zimbabwe were challenging South Africa over bilateral trade negotiations. Zimbabwe was unhappy about the unilateral termination of their bilateral agreement by the former South African government in 1992. They expressed disappointment and frustration that the South Africa was not urgently addressing the issue since their textiles industry was in crisis. Zambia also felt that it was being dealt with unfairly, and was desperate to conclude a bilateral agreement. Both countries accused South Africa of all kinds of chicanery, including 'dumping' of 'subsidised' goods. While much of this was political rhetoric, the Zimbabweans, in particular, had a genuine grievance requiring attention. As a result, there is enormous distrust of South African motives within the region which are used by the EC in their bilateral negotiations with South Africa. To some extent, South Africa's delay in adequately dealing with these concerns has contributed to such perceptions.

4 Cumulation would be applied on the same principles as it applies within the Lomé relationship with the EU, in the sense that inputs originating from within the SADC region would be calculated as comprising part of the 35 percent domestic content. The Malawi delegation has, however, reserved its position.

international relations... Never, however, have notions of sovereignty demanded as much cautious rethinking as now" (1995: 3).

In classical international law, the equal treatment of states is fundamentally correct. Hence the United Nations Charter which deals with issues affecting countries equally recognises this 'sovereign equality' and gives each state represented in the General Assembly an equal vote for decision-making purposes regardless of its size, population or wealth. International lawyers have long upheld this concept, however, the 'sovereign equality' of states becomes meaningless when looked at through the cold lens of international economic relations. It is here that this concept of equality departs from the reality. From the perspective of international economic relations, where global *interdependence* and not independence is the key concern, 'equality' of states becomes illusory. This is demonstrated very clearly in the Southern African region.

IV An Unequal Region

The SADC region is comprised of twelve countries demonstrating varying levels of development.[5] At one end of the spectrum is South Africa whose economy is four times larger than the other eleven SADC countries combined.[6] At the other end are Angola, Lesotho, Malawi, Mozambique, Tanzania and Zambia, as least-developed countries (LLDCs).[7] In the middle range of SADC countries are Zimbabwe, Mauritius, Namibia and Swaziland. Because of the extremely weak and vulnerable nature of LLDC economies, they are entitled to a substantial number of derogations under the WTO regime, and have been accorded as a right, "differential and more favourable treatment" in recognition of their special development needs. This is an acknowledgement that WTO member states are not considered 'equal', and therefore differences in the levels of their development must be accepted in multilateral trade commitments. This latter position was reached after a long struggle to obtain recognition of this fact (starting with the Dillon Round through to the Uruguay Round of negoti-

5 Two more states were admitted to membership of the organisation in September 1997, namely the Democratic Republic of Congo and Seychelles. Since these countries have not yet formalised their membership, they are not considered in this discussion.

6 Within the WTO, South Africa is considered a 'developed' country, but this classification is a misnomer. Since classification in the WTO is by self-selection, South Africa may choose what category it falls under. By the OECD's Development Assistance Committee classification, South Africa is considered 'developing'. Certainly it cannot match Singapore or Israel in per capita GNP, and the latter two are classified in WTO as 'developing countries'.

7 Botswana graduated out of LLDC status in December 1994.

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ations), and it was lobbied for extensively by developing countries themselves.

South African industry may be inefficient in global terms, but it is considered sufficiently competitive in the sub-regional and continental context to have an overwhelming competitive advantage in an SADC FTA. The South African government believes that if tariffs are dropped uniformly and on an equal basis over the next eight years, the results could be devastating for the neighbouring economies. At any rate, South Africa believes that the Protocol places far too much emphasis on the elimination of tariffs and the role of tariff policy while tariffs *per se* are not the issue for two important reasons. First, intra-SADC trade is characterised by unprocessed primary commodities going into South Africa and Zimbabwe, and manufactured goods and semi-processed intermediate products going to the other SADC countries. Given the lack of complementarity of individual SADC countries, and the fact that only South Africa and Zimbabwe have a diversified industrial capacity, this trend is hardly surprising (Ndlela, 1987).[8] It is absurd that the Protocol should emphasise tariff policy for achieving regional goals when only a limited range of tariffs will be in use at any one time by the majority of countries. South Africa will be the only country requiring an elaborate range of tariff lines. Second, for all the reasons stated in the AfDB Study (1993: 23-24 and 36), non-tariff barriers still remain the single most important constraint to intra-regional trade in the SADC region. Thus, the focus of the Protocol on tariffs is totally misplaced.

A more important concern is that while trade with Southern Africa constitutes a small percentage of South Africa's global trade, this trade is growing at a phenomenal pace and has become exceedingly important for the nature of the merchandise being exported. South Africa primarily exports capital equipment and manufactured goods to the region. Excluding Botswana, Lesotho, Namibia and Swaziland, exports to Zimbabwe, Zambia, Malawi and Mozambique account for 64% of South African exports to the African continent as a whole (South African Communication Service, 1996: 187). South Africa has a surplus in excess of 8:1 with the region, which is unsustainable for the other SADC member states. This large and entrenched trade imbalance is unhealthy and could result in impoverishing SADC states. The negative spill-over effects for South Africa would include increased clandestine migration into South Africa of economic refugees and a degree of destabilisation in the region which would dramatically increase its own political and social costs.

8 See also African Development Bank (1993); M.J. Mayer and R.H. Thomas (1997).

Thus what the Protocol should have addressed is how to counter the huge trade imbalances between South Africa and the rest of SADC. Here, the nature of the two-way exchange between South Africa and SADC becomes critical. The Protocol should have investigated the possibility of increasing trade in non-traditional tradables such as, for example, water and energy from the region. Given the abundant endowments of these resources in the region, and South Africa's diminishing domestic resources accompanied by rising demand, trade in energy and water are areas where intra-regional trade may be improved and the trade imbalance redressed.[9] Further, regional cooperation in the implementation of infrastructure projects is critical,[10] as well as cooperation on finance and investment.

For these and other reasons, the manner in which the Trade Protocol develops and that strategies that are used to offset regional inequities becomes absolutely critical from a geopolitical viewpoint and from the perspective of more firmly anchoring regional economic stability. Thus, even the South African Reconstruction and Development Programme policy document has argued that the South African government must develop policies in consultation with its neighbours to ensure more balanced trade. The Government is attempting to do this through the SADC Trade Protocol.

V Article XXIV, the Enabling Clause and MFN

This suggests that whatever relationship is developed under the SADC Trade Protocol, it would certainly need to be flexible in order to accommodate very real divergences between the various parties to the Protocol. Within this context, an important issue for the member states to consider is what would be the most appropriate WTO instrument under which to register the Protocol? Bearing in mind the economic diversity in the region and the required flexibility in approach, should the member states proceed with the more restrictive Article XXIV or should they use the Enabling Clause?

Because of its lack of flexibility on a number of criteria, Article XXIV is a difficult instrument with which to proceed, especially when exploring alternative strategies to maximise the development impact of trade arrangements. SADC member states should instead explore the use of the

9 See, for example, Mayer and Thomas, 1997, p. 39.

10 See Aryeety's paper in this volume; see also the South African Department of Trade and Industry's initiative entitled the *Regional Industrial Location Strategy* which explores the concept of development corridors and clustering in the SADC region.

more flexible 'Enabling Clause', as the region begins to consider how best to develop the 'framework agreement' it adopted at Maseru.

Article I of GATT contains the most-favoured-nation (MFN) clause, which establishes the fundamental principle guiding trade relations globally and is essential to any understanding of regionalism today. It implies non-discrimination among WTO members who are forbidden to selectively grant special trade preferences or privileges to specific other members. The MFN principle is subject to several important exceptions, including Article XXIV and the Enabling Clause. Through these two provisions, customs unions (CUs) and FTAs are tolerated and even encouraged as exceptions to the MFN clause.

Article XXIV envisages four types of arrangements, namely CUs, FTAs and 'interim arrangements' leading to either a CU or an FTA, the objective of which must be "... to facilitate trade between the constituent territories and not to raise barriers to the trade of other contracting parties with such territories" (Article XXIV: 4). Amongst the many agreements which make up GATT 1994,[11] is the Understanding on Article XXIV which requires that all notified agreements be examined by a Working Party and must include a plan and a schedule. The plan and schedule need not be detailed nor contain clear obligations, but the parties must not put any interim agreement into force if they are not prepared to alter it to conform with recommendations made. GATT requires that an interim agreement for a CU or an FTA be established within a "reasonable length of time" (Article XXIV: 7(b)) which the Understanding now places at ten years. Only in extremely exceptional cases may this period be exceeded, and here a period of two years is indicated.

In 1979, during the Tokyo Round, GATT Contracting Parties adopted the agreement *Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries* containing the provisions which make up the 'Enabling Clause'. This created a permanent legal basis for preferences in favour of LDCs or among them, notwithstanding the provisions of Article I. The 'Enabling Clause' was specifically designed to facilitate the economic development of LDCs and LLDCs. For that reason, it is more flexible in its application than Article XXIV. Olivier Long, a former Director-General of GATT, has argued, "Following the entry into force of the so-called 'enabling clause' at the conclusion of the Tokyo Round on 28 November 1979, the preferential agreement between developing countries, and similarly the preferences in their favour granted by developed

11 The Final Act concluded at Marrakesh contains several agreements and 'understandings' on the interpretation of the GATT 1947 provisions, and I refer to this agreement as GATT 1994.

countries, now have a permanent legal basis in the GATT" (Long, 1987: 30). Article XXIV exists for the FTAs of developing country members, and the more advanced LDCs (such as Israel, Singapore and Korea), for which trade liberalisation is the main objective.

Implicit in the heading *Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries* is the notion that LDCs would, with the continued and successful development of their economies and their graduation to a more developed status, be able to "participate more fully in the framework of rights and obligations" under the GATT. This notion of 'fuller participation' by LDCs is the complement of 'differential and more favourable treatment' and provides the basis for a potential reversal of the entitlement. As their situation improves, steps towards progressive 'equality' of treatment should become the rule. Thus, differential treatment should not be prolonged or made immutable, but be time-bound with a provision which underscores the principle that it is not an end in itself, but a vehicle to encourage more rapid economic development.

The WTO Secretariat has reaffirmed the GATT practice in regard to regional arrangements (WTO, 1996) and has acknowledged that a flexible regime for LDCs' trade blocs exists as a continuum from the previous GATT regime. In this context, LDCs have the ability to create an arrangement *sui generis* of Article XXIV provided that it does not prevent the reduction and elimination of customs duties or other trade restrictions on an MFN basis.

While Article XXIV sets out criteria considered by many to be inadequate for both CUs and FTAs, the rules under the Enabling Clause are even less tangible. Indeed, with regard to CUs and FTAs, it has been said that, "in the international system there is no standard model for a trade bloc. There are no standard models for customs unions, or free trade agreements ... Analysis must borrow and synthesise from the practice of existing trade blocs"(Qureshi, 1996: 151-152).

The Enabling Clause permits the actualisation of the principle, 'differential and more favourable treatment' for LDCs. In support of this proposition, Sir Leon Brittan has stated,

> "... the EU encourages developing countries to use regional integration as part of their economic development process. Many of the agreements which result are notified under the 'enabling clause', agreed as part of the Tokyo Round in 1979 to enable special and differential treatment (and more lenient application of GATT rules) to be applied to developing countries. This objective remains important for the EU. Ideally it should be possible to provide for clearer, stronger rules in respect of FTAs and other regional integration agreements

affecting developed and more advanced 'developing' countries (many of whom have a per capita GDP equivalent to EU member states), while at the same time providing for a genuine more relaxed regime applicable to developing countries." (Brittan, 1997)

The phrase 'differential and more favourable treatment' and the principle it espouses is unique in its application to the GATT. It has been a part of GATT language since the early 1970s. The phrase was given more tangible definition to mean *inter alia*, non-reciprocity, or exemption from the MFN requirement in trade relations with developing countries. With the adoption of GATT 1994, 'differential and more favourable treatment', has become codified as a rule of law which is time-bound in its application to LDCs. In respect of LLDCs (with a few exceptions), the rule has indefinite application. Thus the GATT 1994 Agreements have divided LDCs into two groups: LLDCs, and the rest.[12]

The fact that the principle is available *indefinitely* for LLDCs does not mean that it is intended to apply in perpetuity. Rather, its indeterminate nature is a recognition of the extreme uncertainties and difficulties which these countries confront in their efforts to develop, and which makes it nearly impossible to specify in advance how long it will take them to 'graduate' from LLDC to LDC status. But, there is an unspoken assumption that, given the admittedly slow and susceptible nature of attempts at development in LLDCs, the latter will eventually graduate from their unfortunate status. When that happens, the rule falls into disuse and becomes redundant as they will then adopt reciprocal MFN in respect of their trade relations with other WTO member states, and be integrated into the global economy.

The reality of the Enabling Clause, taken with the new WTO rules-based approach to trade relations, indicates that WTO members will not be so tolerant of LDC arrangements registered under Article XXIV that do not comply strictly with the latter provision. The fluidity of the economic conditions of LDCs, and the pregnant expectation that they will advance and move away from a state of underdevelopment, are important factors in the evolution of thought and practice in this area. The Enabling Clause provides inducement for this conceptual evolution with the underlying notion of the 'fuller participation' of advanced LDCs in the implementation of the GATT.

12 This division is, however, not helpful since it groups countries like Swaziland, Botswana and Zimbabwe together with Brazil, Singapore and Israel, and treats them all equally.

VI Conclusion: Trade and Investment as the Driving Forces

If we accept that the aim of integration among LDCs is not simply the efficient use of existing capacity as portrayed in classical CU theory (since this capacity is in any event less developed than is desirable), but that its primary objective is to encourage development and the transformation of production structures through industrial diversification and market expansion (Ostergaard, 1993: 29-34), then we can argue that the Enabling Clause allows member states the flexibility to design an agreement better suited to their circumstances and needs.

SADC member states should therefore notify the Trade Protocol under Paragraph 4 (a) of the Enabling Clause, especially if they want the flexibility to design an agreement more appropriate for their needs, and for safeguarding their economic interests. The effect of registering an agreement under the Enabling Clause would also indirectly indicate that South Africa considers itself as a developing country within the WTO framework. While this would need to be determined when the Committee on Regional Trade Agreements examines the arrangement, it is highly unlikely that the WTO Committee would have any difficulty arriving at the same conclusion as the OECD's Development Assistance Committee which classifies South Africa as an LDC.

How then should the Trade Protocol be framed? First, the primary point of departure should be the need to address investment, especially countervailing investment – and principally, trade-related investment – from South Africa into the other economies of the region. This should preferably occur in amounts which would substantially offset the massive trade surpluses in favour of South Africa from intra-regional trade. The reality is that the size of South Africa's trade surplus vis-à-vis the rest of the region is so large as to be unsustainable and unfinanceable. With most SADC economies being highly dependent on foreign aid, it would be unrealistic to expect donors to keep providing exceptional levels of balance of payments support to these countries simply to finance imports from South Africa.

A second and more important reason why the Protocol should focus more heavily on investment measures is that in the absence of inductive capital flows from South Africa, it is extremely unlikely that private capital flows from the rest of the world will materialise if primary flows from South Africa do not lead.[13] For this reason, SADC needs to conclude a

13 The region's investment-risk profile is still too high to encourage normal FDI. The only type of investment that seems to be materialising lately is in mining, where the risk profile is not as important a consideration. Southern Africa needs to attract more investment in productive capacity, but this is not happening.

complementary Protocol on regional investment policy, to supplement the Trade Protocol, as soon as possible. The former would need to target or facilitate cross-border movements of capital in the short term and the issue of the clearing of payments. More particularly, it should not be detailed and complicated, but should be designed to meet the needs of countries at various levels of development. Certainly, there will be need for very close collaboration between the Trade and Industry and Finance and Investment sectors.

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Regional Economic Interaction in the Middle East and North Africa

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I Introduction

Regional economic interaction in the Middle East and North Africa (MENA) is relatively low: trade flows are limited in size and concentrated in composition; labour movements, while significantly more important, are skewed and have been subjected to a range of non-economic disruptions; tourism flows are segmented within the region; and residents' capital holdings have been often invested outside the region rather than in other countries within the region.[2]

The reasons for the limited amount of regional economic interaction are mainly economic and security related. Until recently, the economic policy stance of several countries has tended to limit integration with the international trade and financial systems, let alone within the region. On the security front, the region has had its host of problems, particularly in the context of the prolonged Arab-Israeli conflict.

While economic interaction has been limited, there has been no lack of recognition among governments of the region of the potential benefits of deeper integration in the region and/or among subgroups of countries in the region.[3]

Indeed, the region's history is full of attempts at greater integration –

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2 For the purposes of this paper, MENA is defined to cover the members of the Arab League, the Islamic Republic of Iran, and Israel (see box). The paper builds on the analysis contained in El-Erian and Fischer (1996) and El-Erian and El-Naggar (1996).

3 Interest in regional integration is not unique to MENA. Indeed, interest in regionalism, or what is often labeled as "new regionalism," has become quite broad, with some analysts seeing it as the second most powerful force currently reshaping the world economy – the first being globalisation. See, for example, de Melo and Panagariya (1993), Hine (1992), Keating and Loughlin (1997), Mistry (1996), OECD (1993), and Teunissen (1995 and 1996). Borrman and Koopmann (1994) noted that regional trade under formal integration arrangements covered 45% of total trade due, primarily, to developments in the European Union.

MENA at a Glance

Coverage. The MENA region is defined to encompass the economies of the Arab League (Algeria, Bahrain, Djibouti, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, Palestine, Qatar, Saudi Arabia, Somalia, Sudan, the Syrian Arab Republic, Tunisia, the United Arab Emirates, and the Republic of Yemen), as well as the Islamic Republic of Iran and Israel. The region possesses abundant natural resources and, on average, enjoys a reasonable standard of living. However, individual countries exhibit a broad diversity of characteristics. They vary substantially in natural resources, economic and geographical size, population, and standards of living.

Size. The MENA region covers an area of more than 15 million square kilometers and contains more than 300 million people, roughly 6 percent of the world's population. The population of individual countries varies considerably – the smallest among them have a population of about half a million (Bahrain, Djibouti, and Qatar) and the largest have populations of some 60 million (Egypt and the Islamic Republic of Iran). The nominal GDP of the region amounted to over $600 billion in 1996, roughly 2 percent of world GDP and about 11 percent of developing countries' GDP.

Population growth. Many MENA countries are experiencing rapid population growth and have a high proportion of young dependents among their population. The average increase in population in recent years has been about 3 percent, although a group of countries (Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates) have registered a higher rate of growth of 3.5 percent. Bahrain, Egypt, Lebanon, Morocco, and Tunisia have recorded relatively low rates of population growth (of about 2 percent) compared with the average for developing countries as a group.

Per capita income. The region includes some of the poorest countries in the world, with per capita incomes around $200 (Somalia and Sudan), as well as countries among the high-income groups, with per capita incomes ranging between $14,000 and $18,000 (Israel, Kuwait, Qatar, and the United Arab Emirates).

Regional subgroupings. Many subgroupings have been used in the literature. The most common include:

- *Oil economies.* Ten MENA countries are classified as oil exporting countries. They are Algeria, Bahrain, the Islamic Republic of Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. Although other countries (such as Egypt, the Syrian Arab Republic, Tunisia, and the Republic of Yemen) also export oil, the role of this sector in their economies is relatively limited.
- *Cooperation Council for the Arab States of the Gulf (GCC).* Member countries of the GCC are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.
- *The Arab Maghreb Union (AMU).* The members are Algeria, Libya, Mauritania, Morocco, and Tunisia.
- *Mashreq.* This group consists of Egypt, Israel, Jordan, Lebanon, the Syrian Arab Republic, and West Bank and Gaza Strip.

Source: International Monetary Fund, Building on progress: reform and growth in the Middle East and North Africa, IMF, Middle Eastern Department, Washington, D.C., 1996.

mainly through bilateral trade agreements among Arab countries. In the design of these agreements, governments have rightly sought to exploit opportunities for welfare-enhancing economic interactions, strengthen the collective political bargaining power vis-à-vis other countries, and achieve other non-economic national goals (namely, greater national security). Their effectiveness, however, has tended to be quite limited. This history of bilateral agreements led one observer to note that in certain regions of the world one finds regional trade, in MENA one just finds regional trade agreements!

In the last five years, the MENA region has witnessed three major initiatives aimed at enhancing regional interactions. First, efforts launched after the Oslo agreements and Madrid meeting (both relating to Arab-Israeli relations); second, the pursuit of regional integration through the indirect route of linkages with another region (e.g. through "Association Agreements" between certain countries of the region and the European Union (EU)); and third, and most recently, efforts toward creating an "Arab Common Market" (ACM) starting with a subgroup of countries, if necessary.

The purpose of this paper is twofold: first, to provide insights into the reason for the limited regional interaction to date; and second, to identify the main factors that will influence the effectiveness of future interaction, including various integration initiatives. To this end, Section II, documents and explains why, despite various official initiatives and favourable initial conditions, regional interaction has been limited overall and very skewed in terms of activities. Recognition of the resulting adverse economic welfare effects, as well as non-economic factors, is behind the current resurgence in interest in regional integration. As discussed in Section III, the prospects for regional interaction (both regionalism and regionalisation) will be determined by two sets of competing forces. On the one hand, the favourable recent developments in individual countries' enabling economic environments (the "economic fundamentals") and, to a lesser extent, the catalyst of the Association Agreements with the EU will encourage regional interaction, as well as progress on the creation of the ACM. On the other hand, the uncertain political dimension will act as a damper for *region-wide* integration. Accordingly, the paper concludes that what is likely to emerge over the next few years is greater interaction among *subgroups* of countries in the region (the Arab ones) – particularly in the form of regionalism – with positive welfare effects.

II The Extent of Regional Economic Interaction in MENA

Regional economic integration is a broad concept. It can cover not only strict economic relationships among goods and factors of production in a region (also known as "market integration"), but also legal and institutional relationships ("institutional integration").[4]

The instruments of regional integration are also quite broad, ranging from informal and non-directed mechanisms to institutionalised ones such as custom unions and free trade arrangements.[5]

In reviewing the extent of regional economic interaction, this section looks at four factors which impact both elements of economic integration: trade in goods, labour movements, other market integration channels, and policy coordination mechanisms. It is argued that, in MENA, these ingredients of integration have been extremely limited at the level of the region *as a whole* – both in absolute levels and relative to other regional groupings (formal and informal). Moreover, the most important ingredient of regionalism in the MENA region – *viz.*, that based on labour flows – has been subject to significant non-economic disruptions. At the sub-regional level, there have been more pronounced cases of effective integration.

4 See Cooper (1974).
5 The latter differentiate regionalisation from regionalism.

Trade in Goods

Trade among countries in the MENA region is relatively limited. In the 1990s, such trade averaged around 7.25% of the region's total trade (see Table 1 at end of paper).[6] The share has been a relatively stable one, fluctuating for the most part in the 6-8% range (Chart 1). By contrast, trade with countries in the European Union has averaged some 43% in the 1990s, with a higher share of imports from the EU (48%) than exports to the EU (38%).

The extent of regional trade is limited not only at the aggregate level, but also at the country and product levels. Thus, for no country in the region does regional trade account for more than 25% of total trade.[7] On the product side, there is no category for which MENA trade is very important, with the exception of mineral fuels.[8]

Table 2 (at end of paper) compares regional trade in MENA to some other country groupings based on the same methodology and source of statistics. In the 1990s, MENA had the lowest incidence of regional trade. While regional trade in Africa is only somewhat higher, it is significantly larger in other industrial and developing country regions – ranging from almost 20% in Mercosur to over 60% in APEC and the EU.

A cursory look at the composition of MENA's trade suggests that the limited intra-regional trade is not really an issue of product composition. While exports of primary products (mainly oil) are important, the region also has a solid base of exports of manufacturing goods and foodstuffs. This is particularly so for the non-oil exporting countries where manufacturing products have accounted for 54% of their total exports in the 1990s. On the import side, the structure is dominated by manufacturing goods (67%), followed by commodities (15%) and foodstuffs (12%). The recent work by Havrylyshyn and Kunzel points to the potential for complementary trade for the group of Arab countries.[9]

Labour Movements

In contrast to trade in goods, labour movements have been an important

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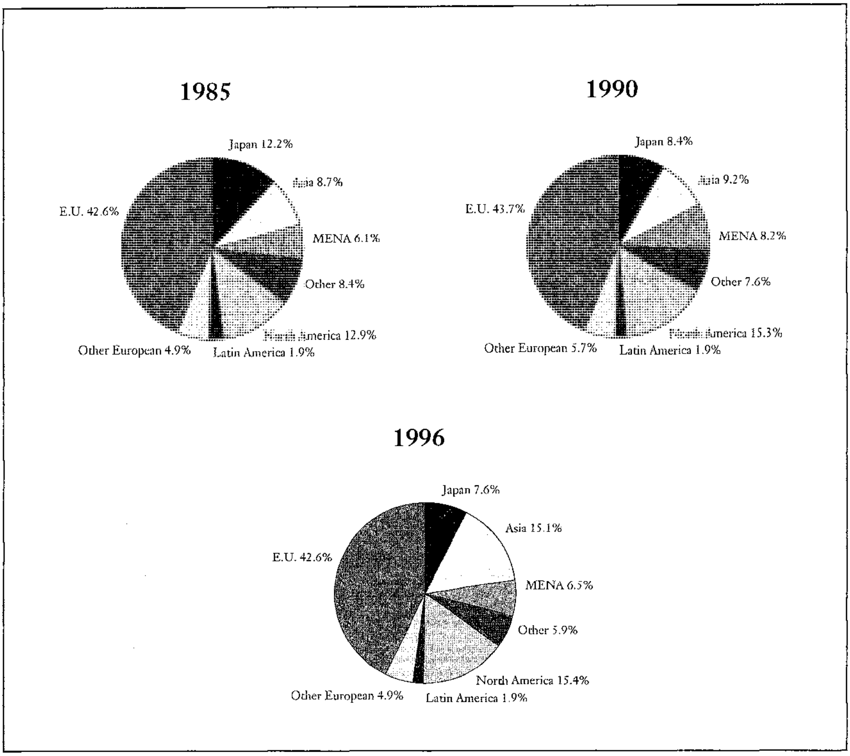
6 The unweighted country average is also under 10%. The measure does not include informal border and suitcase trade. While such trade exists, its magnitude is not thought to alter significantly the argumentation in this paper.

7 The countries with the highest share of regional trade in the first half of the 1990s were Bahrain (23%), Oman (14%), Jordan and Syria (both 14%); those with the lowest were Israel (0.1%), Algeria (3%), and Kuwait (4%).

8 See Fischer (1993).

9 Havrylyshyn and Kunzel (1997).

Chart 1 MENA: Direction of Trade, 1985, 1990, and 1996



element of interactions among countries in the MENA region. Thus, it has been argued that trade in labour services has been the most successful element of regional integration.[10] This is seen to have given rise to a curious phenomenon whereby labour movements were the first rather than the final and most controversial aspect of regional integration, as is normally the case.

Labour migration has reflected the large differences in factor endowments between the relatively populous non-oil economies in the region, and the oil economies with small populations (essentially members of the Gulf Cooperation Council (GCC) and Libya).[11] While significant in number, labour flow patterns have been subject to significant disruptions. This

10 See Shafik (1992).

11 The six GCC countries are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

zFrom: *Regional Integration and Multilateral Cooperation in the Global Economy*
FONDAD, The Hague, 1998, www.fondad.org

is illustrated in considering the two types of flows that have dominated regional labour movements over the last 25 years: (i) flows from non-oil Arab economies to the Arab oil economies; and (ii) Palestinian workers employed in Israel.

In the case of the first type of flows, it is estimated that about two-thirds of the eight million migrant workers in the six members of the GCC in 1985 were from other Arab countries.[12] While comprehensive numbers are hard to come by, it is believed that this number has declined. There has also been a change in composition in some countries. In Kuwait, for example, a significant proportion of the Jordanian, Palestinian, and Sudanese labour flows before the 1990-91 regional crisis has been replaced by Eastern Asian workers and higher inflows of other Arab nationalities (especially Egyptian).[13]

In the case of the second type of flows, the variability has also been significant, if not considerably higher. Indeed, since 1992, Palestinian labour employed in Israel has fluctuated from levels well in excess of 100,000 (over 25% of total Palestinian employment) to virtually zero. As regards annual averages, these have ranged from 116,000 in 1992 to 25,000 in 1996. The movements have not only been large in size but also subject to dramatic sudden changes, with considerable direct and indirect effects on private incomes, the government budget, and neighbouring economies.[14]

The fluctuation in labour movements has been associated with an important institutional/legal aspect. MENA workers have not enjoyed the type of structure that is found in the EU for example, where citizens of one country enjoy the legal right to work in other countries within the region.

Other Flows

Data on other flows are more limited. *Tourism and non-factor service flows* have appeared quite segmented, with significant regional flows limited essentially to Egypt, Jordan, Lebanon, Morocco, and Tunisia. *Capital flows* have also been limited, with the exception of the very large official flows from the oil-exporting Arab countries to other Arab countries, particularly following the 1973-1974 and 1979-1980 international oil price increases, and the continued activities of Arab regional institutions (particularly the Arab Fund for Economic and Social Development and the Arab Monetary Fund).[15]

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12 See Klinov (1991).
13 See Chalk, El-Erian, Fennell, Kireyev, and Wilson (1997).
14 See Zavadjil, Calika, Kanaan, and Chua (1997).
15 Van den Boogaerde (1991) provides information on official capital flows.

Regional Policy Coordination

There have been no effective mechanisms for regional policy coordination for the region *as a whole*. Mechanisms for resolving economic disputes have been virtually non-existent and regional channels for exchanging macroeconomic information have been extremely limited.

The closest countries in the region have got to *region-wide* economic dialogues has been through the series of "economic summits" launched in 1994 in Casablanca. However, while including Israel, they were not attended by certain Arab countries and the Islamic Republic of Iran. Also, they have not taken the nature of coordination summits with the exception of some projects in tourism and cooperation by chambers of commerce. With the deterioration in Israeli-Palestinian relations since 1996 and related setbacks to the peace process, the "summits" have been downgraded to the concept of a regional economic "conference". Indeed,Van den Boogaerde (1991) provides information on official capital flows. the November 1997 conference held in Qatar was poorly attended by countries in the region as several Arab governments expressed frustration at the hardening of the Israeli positions in the peace process.

There has been better policy coordination at the sub-regional level, with some notable successes. The fora for such coordination include: (i) the GCC (the closest the region gets to regionalisation); (ii) through the mechanism of OPEC and OAPEC; and (iii) in the context of the activities of the Arab financial institutions and the Arab League. Other attempts, such as the Arab Maghreb Union, have been of very limited success.[16]

III Why Has Regional Interaction Been So Limited?

The above-cited indicators of limited regional economic interaction contrast strongly with the repeated efforts by governments to implement cooperation agreements among groups of Arab countries in the region. They also contrast with the economic, geographical and cultural characteristics of the region that point to gains from increased regionalism.

As in other regions, there were three reasons behind most attempts at regional integration: (i) economic welfare gains; (ii) enhanced collective political bargaining power in extra-regional affairs; and (iii) non-economic national goals (especially, security-related ones).[17]

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16 Members of the AMU are Algeria, Libya, Mauritania, Morocco, and Tunisia. For a discussion of the AMU, see Finaish and Bell (1994).

17 For a survey of regional integration issues, see OECD (1993). Reviews of the operation of regional trade arrangements may be found in Brown (1994), de la Torre and Kelly (1992), de Melo and Panagariya (1993), and IDB (1997).

On paper, these reasons should be facilitated by economic, geographical and cultural conditions that are conducive to regional integration in MENA.

- On the *economic* side, the region has a diverse natural, human, and financial endowment that is spread among countries in the region. The regional market offers considerable purchasing power and there are indicators of trade-creating gains.

- On the *geographical* front, the region covers a large contiguous land mass which is rich and diverse in natural resources (oil, gas, non-fuel minerals, agriculture pockets, etc.). Regional trade routes are, on paper, relatively accessible.

- On the *cultural* front, the extent of language and religious coherence compares favourably with other regions such as the EU and ASEAN.

These factors suggest that the level of regional economic interaction should be larger than what currently exists. Or, to use the traditional terms, it would appear that there are good reasons for trade-creating (as opposed to trade-diverting) forces under an integration arrangement, given what appears to be unexploited "natural trading" opportunities.[18] This trade-creating element is related to cost-reducing economies of scale associated with the factors cited above. There would also be an impact on the pattern of foreign direct investment and portfolio flows, including that originating from outside the region. Finally, for several economies in the region, efficient regional cooperation can help overcome the disadvantage of their relatively small size in the world economy.

As indicated in El-Erian and Fischer (1996), it is important to stress that what is being argued here is not necessarily that economic factors point to an *a priori* scope for regional economic interaction that is overwhelmingly large; nor is it argued that increased regional interaction need necessarily be pursued through formal discriminatory arrangements. Rather, the arguments in this paper call for countries in the region to continue to interact mostly with non-regional partners while enhancing the level of regional interaction which, at this point, is well below what would be attained if economic relations among countries in the region were subject to fewer economic and political constraints.[19]

18 This argumentation is developed by, for example, Langhammer (1992) and Borrman and Koopman (1994).

This argumentation is closely related to the importance of viewing regional integration initiatives as consistent with multilateral liberalisation rather than as an obstacle or a substitute for it. In this regard, and as discussed further below, the complementarity of regionalism and multilateralism depends essentially on three factors: first, ensuring that the regionalism is "open" – i.e. accompanied with liberalisation versus other regions; second, avoiding that work on regional issues detract from preoccupation with multilateral issues; and, finally, avoiding that vested interests' opposition to regionalism compound unduly so that they effectively oppose multilateralism.

What, then, are the most important constraints? Two stand out in importance: the enabling economic environment (at both the individual country level and structural rigidities at the regional level); and the political dimension.

The Enabling Economic Environment

It is critical that the economic environment in the countries in the region is such as to enhance trade. Until recently, the Arab region's external trade and investment relations have been undermined by the legacy of the inward-oriented public sector-led development strategies pursued by most non-oil countries in the region. It is, therefore, no surprise that the limited intra-regional economic activity had been accompanied, until recently, with limited interaction with the rapidly globalising international economy.[20] Thus, at a time when developing countries' share of the booming international trade grew (from 23% in 1985 to 29% in 1995), that of the Arab economies declined (from 5% to 3%); moreover, trade (as well as foreign direct investment) remained concentrated in the energy sector. At the same time, these countries attracted less that 1% of the flow of portfolio capital to developing countries.[21]

Appropriate economic policies are a prerequisite for the deepening of efficient international economic links – be it within a region or with partners outside the region. Among the factors stressed by recent studies are: (i) macroeconomic stability; (ii) openness of trade and payments regimes;

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19 A good illustration of this is the Maghreb sub-region. Because of some similarity in resource endowments and the greater proximity of the Maghreb countries to Europe as compared to the MENA Mashreq countries, the Maghreb will continue to trade mostly with non-regional partner countries in Europe. Nevertheless, there are gains to be attained from deeper economic interaction within Maghreb, including through the attraction of foreign direct investment to supply a considerably larger market.

20 See El-Erian (1997).

21 Additional information is contained in El-Erian and Sheybani (1997).

(iii) government intervention in the economy in support of (rather than substitute for) private sector activity; (iv) financial sector deepening; (v) sound human resource development policies; and (vi) strengthened institutions, governance, and information flow. Recent studies also stress that there is no single policy that is sufficient to ensure a favourable outcome. Rather, economies need at least a moderate degree of success on several policies.[22]

The recent economic history of the region is well documented.[23] Studies tend to stress not only the region's limited integration through trade and capital flow but, importantly, its limited ability to generate sustained high growth. Thus, thc rcgion's per capita income level in 1995 was somewhat lower than a decade earlier – this at a time when developing countries as a group saw their per capita income rise by over 40% while that of the Asian economies increased by over 80%. Not surprisingly, investment and saving rates remain well below the averages for developing countries, let alone the fast growing ones.

There are several inter-related reasons behind the disappointing growth performance and several MENA's countries' relatively limited interaction at a regional level and with the world economy. Since this paper does not provide an appropriate forum to delve into this topic, we will limit ourselves to two observations. At the most basic level, there is now widespread agreement that the domestic policy stance in most MENA countries was not strong enough to offset the deterioration in the external economic environment (particularly the weakening international terms of trade). The following economic factors have tended to attract attention in recent studies on the particular aspects of the region (especially for the non-oil economies)[24] – factors that are now being addressed in several countries by comprehensive adjustment and reform policies:

- Investment activity that was overly directed by the public sector, low in efficiency, involving limited growth in total factor productivity, and dependent overall on outside (and volatile) sources;

- Financial intermediation processes that were insufficiently market-based for the mobilisation and allocation of loanable funds, thereby placing excessive emphasis on selective credit allocation mechanisms and involv-

22 See for example the study of 110 developing countries contained in Aziz and Wescott (1997).

23 For recent analyses see World Bank (1995) and IMF (1996).

24 These include Alonso-Gamo, Fedelino, and Paris-Horovitz (1997), Bisat, El-Erian, and Helbling (1997), Chabrier and Kanaan (1997), and Moalla-Fetini and Waterbury (1997).

ing an inherent bias against domestic savings mobilisation; they did little to impose discipline on the enterprise sector;

- An external trade regime that tended to undermine export activity and overly limited the degree of competition faced by domestic producers, as well as limiting consumer choice; and

- A public/private sector balance in which the public sector often ended up substituting (rather than complementing) private sector activity; at the same time, some of the existing private sector activities tend to depend on rents and on the largess of the public sector, preferring to be shielded from external competition.

These factors inhibit trade and investment interaction at the regional and international levels. They were compounded by structural rigidities. These include divergences in regulatory frameworks, including customs nomenclatures which impact directly on trade. Moreover, regional road and rail transportation facilities have remained limited, and regional infrastructural projects have been constrained by a host of restrictions. Also, the region *as a whole* has not benefited from a strong institutional setup that provides a forum for discussion of regional issues and harmonises policies where needed. Indeed, it is this recognition that has led to efforts to establish the Middle East Development Bank.

The Political Dimension

MENA has had more than its share of political conflicts. These conflicts have impacted economic relations at both the country and regional level. The Arab-Israeli conflict has been, by far, the most protracted conflict in MENA. With the largest range of direct and indirect economic and financial repercussions,[25] it has resulted in four regional armed conflicts in the past 50 years, a series of border clashes and incursions, and spillover effects in other regions. It has fostered for years a high degree of deep mistrust and hostility.

Regional economic activities have also been undermined by other political differences, including those triggered by Iraq's invasion of Kuwait in 1990 and developments in North Africa which have inhibited cooperation among members of the Arab Maghreb Union (AMU). The diversity of political systems and governance may also have played a role in limiting regional economic activities. The argument here is that the less similar the

25 See, for example, papers in Fischer, Rodrik, and Tuma (1993).
26 This is the line taken in OECD (1993) for example.

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political institutions and systems of governance among countries in a region are, the more difficult and less effective the process of regional integration becomes.[26]

With the various conflicts and political differences, it is perhaps not surprising that there has not been a broad commitment at the national level to regional economic goals. After all, such commitment implies yielding a certain amount of economic and financial sovereignty from the country to the regional level – a process that raises all sorts of issues as demonstrated, most recently, by developments in the EU. In the case of MENA, such political and governance issues have repeatedly led to national considerations undermining regional efforts, including in the context of translating regional aspiration into an effective and independent institutional foundation.[27]

IV Prospects for Regional Integration

The previous section's review of the main factors that have determined the pace of regional economic interaction in MENA forms the basis for evaluating the prospects. Thus, it is clear from above that the prospects for regional economic interaction depends on improving the enabling economic environment and overcoming the considerable political hurdles. It is in this context that the more focused efforts bear fruit.

There is now increased attention being devoted to integration efforts in MENA, be it through informal channels in the form of linkages to Europe, a new Arab Common Market or region-wide arrangements. The analysis detailed below comes out with four main findings of relevance to these efforts.

1. For an increasing number of countries in the region, the economic preconditions for integration (regionalism and regionalisation) have become more favourable.

2. The political aspects, however, and especially those linked to the resolution of the Arab-Israeli conflict, remain difficult.

3. Successful integration efforts are more likely to happen among subsets of countries in the region than at the level of the region *as a whole.*

4. These efforts may well be given a boost by the ongoing process of nego-

27 See Ghantus (1982).

tiations of "Association Agreements" between the EU and countries of the southern and eastern Mediterranean, as well as the renewed political emphasis on an Arab Common Market.

A Changing Economic Landscape

In reaction to both the disappointing growth performance discussed above and policymakers' increasing recognition of the dangers of marginalisation in the rapidly globalising world economy, several MENA countries have stepped up their process of economic adjustment and reforms. Responding to the strengthening of policies and favourable external terms of trade developments, the region's growth rate doubled in 1996 (to almost 5%), while inflation, the current account deficit, external debt indicators, and foreign exchange reserves were at their most favourable level this decade (Chart 2). Macroeconomic conditions remained favourable in 1997 as reflected in a second year of per capita income growth, and further reductions in domestic and external financial imbalances.[28]

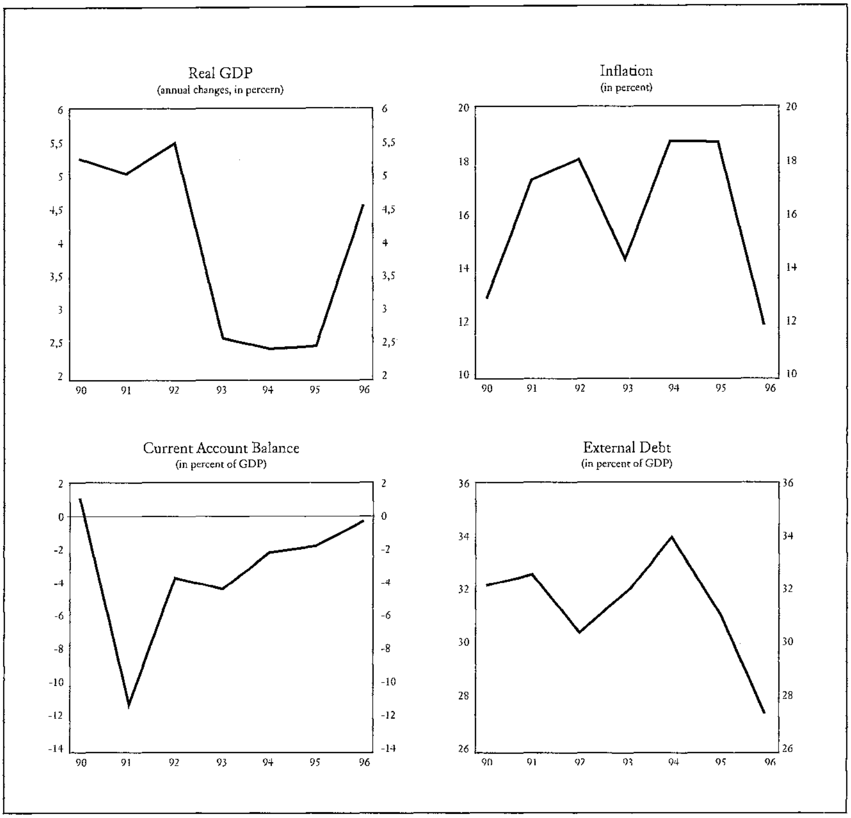
MENA's economic and financial improvements have been noted by the international markets. Larger amounts of capital have been channelled to the region. Several public and private sector entities are now able to directly tap the international capital markets, assisted by the favourable credit ratings obtained by several countries in the region. Institutional linkages with international firms are increasing. While the disruptions in Southeast Asia are expected to result in a decline in overall private flows to developing countries, the share of MENA is expected to increase and, also perhaps, the absolute amounts.

These favourable changes in the region's macroeconomic indicators and linkages with the international system are to be welcomed. Equally important, if not more, are the underlying changes in the economic structure of the non-oil MENA economies. Thus, several countries have taken important steps to reduce the level of tariff and non-tariff protection, deregulate domestic activities, and improve the intermediation of funds mobilised domestically and abroad. This is part of the large move away from a public sector led import-substitution strategy to one where the private sector takes the lead with public sector support rather than substitution.

Trade liberalisation. The non-oil MENA economies have some of the highest rates of tariff protection in the world.[29] This has inhibited their export activities without a pronounced return in terms of establishing a

28 See El-Erian and Fennell (1997).
29 For details see Alonso-Gamo, Fennell, and Sakr (1996).

Chart 2 MENA: Selected Economic Indicators, 1990-1996



solid domestic production base; it has also undermined consumer welfare. Not surprisingly, therefore, tariff reductions have been an important part of reform programmes in the region. For example, Egypt has reduced its maximum tariff rate from 70% in August 1996 to 50% in June 1997, and Jordan has reduced its rate from 70% in December 1996 to 40% in June 1997. While the non-oil economies still have higher tariff rates than most other developing countries, these recent moves will facilitate their faster integration in the world economy.

Domestic deregulation. Concurrent with the reduction in tariff rates, several countries have taken steps to deregulate domestic activities (e.g. Egypt, Jordan, Morocco, and Tunisia). Measures have focused on privatisation and opening up sectors previously reserved for the public sector (e.g. airport, ports, roads, and power generation). Indeed, several countries, including in the GCC, are exploring ways for greater involvement of the private sector in large infrastructure projects. Steps have also been taken to reform investment regulation, especially as applicable to foreign direct investment.

Financial reform. In an attempt to improve the process of mobilising and allocating loanable funds, several MENA countries are promoting the role of market forces in the mobilisation, pricing, and allocation of financial resources while, concurrently, strengthening prudential supervision and regulation.[30]

Institutional linkages. With the improvement of the enabling economic conditions, we are witnessing increased institutional linkages within the MENA region. Recent advances have included the linking up of the Cairo, Beirut, and Kuwait stock markets. Progress, albeit slow, is also being made in establishing the MENA Bank. The Bank is to provide a wide range of assistance to the region's private sector and help finance regional projects. It can also provide an important forum for countries to discuss regional economic issues. All in all, the MENA Bank offers a cost-effective option for supporting the development of economies in the region while minimising the duplication of the activities of existing institutions.

The Catalyst of Europe

The last two years have seen intensive negotiations between the EU and southern and eastern Mediterranean countries in the context of the EU's "Mediterranean Basin Initiative." As of October 1997, Israel, Morocco, and Tunisia had finalised "Association Agreements" with the EU; Jordan and the Palestinian Authority had initialled agreements; and Algeria, Egypt, Lebanon, and Syria were in the process of negotiation.

These agreements have an important trade component which is of relevance to this paper's discussion. Specifically, they entail the creation over 12 years of a free trade area for most products between the EU and countries of the southern and eastern Mediterranean. The dismantling of tariff and non-tariff barriers in the latter group of countries is to be facilitated by the provision of EU assistance of some ECU4.7 billion, with a corresponding amount from the European Investment Bank.

On paper, the Association Agreements with the EU offer the prospects of benefits in the form of increased bilateral trade and, potentially more

30 These efforts are discussed in Chalk, Jbili, Treichel, and Wilson (1996).

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important, from higher foreign direct investment. Given the favourable access that MENA countries already enjoy to the industrial product markets in MENA and the absence of aggressive liberalisation of EU agriculture, the static trade gains appear limited.[31] The large potential gains result much more from dynamic factors such as the associated changes in productivity levels and the advantages of being anchored to Europe, including beneficial effects on investor perceptions. Indeed, most studies of regional integration efforts – covering both successes and failures – emphasise the impact on investor expectations of economic policy convergence and harmonisation of regulatory and supervisory regimes.

Putting aside discussions on the components (actual and potential) of the current Association Agreements, it is generally recognised that, if well managed, the Association Agreements with the EU can not only enhance the economic environment in several MENA countries, but also provide a catalyst for regional MENA integration as a stepping stone to multilateral liberalisation. A thorough discussion of this issue is contained in Havrylyshyn's recent works, as well as in the volume edited by Galal and Hoekman. For the purposes of our discussion, there are two important elements to note: (i) the cumulative rule-of-origin principle applicable to the MENA partners; and (ii) the incentive for MENA partners to reduce the risk of foreign investment taking the "hub-and-spoke" form whereby the incremental direct investment locates in Europe to access the new southern and eastern Mediterranean markets. In both circumstances, the benefits are maximised and the risks reduced if MENA countries integrate more with each other.

This argument has important implications for the renewed emphasis on Arab economic integration. Simply put, by opening up to each other, Arab countries will increase the welfare benefits of their other economic liberalisation efforts, particularly vis-à-vis the European Union.[32]

An Uncertain Political Dimension

The factors cited above have the potential to facilitate greater regional interaction in the context of a faster integration with the world economy. The improvement in the enabling economic environment, in particular,

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31 There is a concern here that the process is not comprehensive across sectors (let alone covering labour) and does not involve reciprocity on the part of all trading partners. Thus, the current exclusion of agriculture from the EU's liberalisation process will entail welfare losses for the countries of the southern and eastern Mediterranean.

32 For example, initial general equilibrium model work on Egypt by Hoekman, Markus and Konan suggest that the welfare gains of free trade agreements with both the EU and the US increase dramatically if accompanied by an Arab free trade agreement.

may be thought of as a necessary, but not sufficient, condition. Indeed, region-wide interaction will continue to be constrained by the unsettled Arab-Israeli political conflict.

Already in 1996 and 1997, several Arab countries have slowed down their process of economic normalisation with Israel in response to the deteriorating Israeli-Palestinian relations and other setbacks to the eventual establishment of a comprehensive, just, and durable peace. Moreover, participation in the 1997 MENA Economic Conference was limited. Accordingly, the resumption of region-wide integration efforts will depend on attempts to restore confidence in the peace process. It should also be noted that even with progress in the peace process, it will take time to overcome the suspicion and hostility associated with what has been a prolonged and costly Arab-Israeli conflict.

Putting it Together

In sum, the region faces two conflicting forces with respect to greater regional economic interaction. On the one hand, favourable developments in the enabling economic environment and the catalyst of the EU Association Agreements will encourage regional interaction. On the other hand, the uncertain political dimension will act as a damper. Accordingly, what is likely to emerge is greater economic interactions among subgroups of countries – in the form of further integration of the six members of the Gulf Cooperation Council and greater interaction among other subgroups of Arab economies. Such interactions will benefit from reduction in tariff and non-tariff barriers (including simplifications in and harmonisation of administrative and regulatory regimes). Unlike past attempts, this one will need to be driven operationally by the private sector rather than by agreements among public sector entities.

In pursuing such interaction, Arab economies will need to be mindful of the implications for multilateralism. In particular, the interactions should be seen, and therefore designed, as consistent with the much needed multilateral liberalisation rather than a substitute for them.[33] Otherwise, there will be significant welfare losses as a result of traditional trade diversion effects. Moreover, a "closed regionalism" is unlikely to prove attractive to sustained high foreign direct investment.

For regional integration to prove consistent with, if not conducive to, multilateral liberalisation, it needs to be accompanied as soon as possible

33 The risks are put starkly by Borrman and Koopman (1994) who note that regional integration could well be viewed as "an institutionalised beggar-thy-neighbour policy." See also discussion in Bhagwati (1993), Krugman (1993), and other papers in de Melo and Panagariya (1993).

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by liberalisation vis-à-vis the rest of the world and pre-emption of the blocking power of vested interests. It is such considerations that have led people like Bhagwati to propose the early specification of specific measures to move from regionalism to multilateralism.[34]

V Concluding Remarks

The MENA region remains strikingly unintegrated in economic terms when compared to Europe, Asia/Pacific, and Latin America. Trade in goods is limited; labour flows, while significantly more important, are skewed and subject to frequent disruptions; residents have tended to invest funds outside the region rather than within; and the region-wide institutional base remains partial. The limited amount of regional interaction has had direct adverse economic welfare effects, as well as weakening the region's position in extra-regional economic negotiations.

It is therefore not surprising that renewed emphasis is being placed on greater regional integration involving groups of Arab economies and through the indirect route of Association Agreements with the EU. The prospects for such integration efforts are being boosted by the improvements in the enabling economic environment. However, political conditions, particularly the Arab-Israeli dimension, are likely to limit a more general progress in regionalism at this stage. Accordingly, what is likely to materialise is closer integration between subsets of countries in the region, particularly Arab ones, with potentially important welfare gains (direct and indirect) provided the discriminatory aspects are minimised.

The policy changes that are required for successful economic integration are the same as those needed if the countries of the region are to benefit from the more general process of globalisation and integration in the world economy. This point is best illustrated by the dynamic Asian economies where outward-oriented development strategies have been associated with intensified regional economic interactions without the implementation of significant discriminatory measures.

Progress in regionalism is therefore primarily dependent on policy changes at the country level. Specifically, continued progress in reducing financial imbalances needs to be supported by the widening and deepening of structural reforms aimed at promoting private sector-led growth and investment and a greater outward orientation of the economy.

34 Wei and Frankel (1995) show both theoretically and empirically that in a world of "simultaneous continental trade blocs" relatively modest liberalisation with the rest of the world produces Pareto improvements. See also discussion on East Asia contained in Lloyd (1996) and De Rosa (1997).

These general policy changes hold the key to enhancing regional interaction in the context of a region that is growing economically, providing jobs for its increasing population, and better integrating regionally as well as internationally. The process of regional integration will also be assisted by steps targeted specifically at greater regional interaction including reducing divergences in regulatory frameworks, improving transportation and transportation networks, realising certain regional projects, and ensuring a strong institutional structure.

Table 1 Direction of Trade, 1970-1996[1]
(percentage of total trade)

	1970	1975	1980	1985	1990	1991	1992	1993	1994	1995	1996
Trade of MENA with:											
MENA	5.4	4.7	3.7	6.1	8.1	7.2	7.2	7.5	7.7	7.0	6.5
Asia	5.1	5.9	8.1	8.7	9.2	11.1	12.0	12.1	11.9	14.2	15.1
Japan	5.7	10.5	11.8	12.2	8.4	8.9	9.3	8.7	8.2	7.6	7.6
European Union	53.4	47.0	44.6	43.5	43.7	43.4	42.8	43.3	43.0	42.0	42.6
Other European	8.9	4.9	2.9	5.9	5.7	5.0	4.1	4.0	4.2	5.1	4.9
Latin America	2.0	5.4	2.6	2.3	1.9	1.9	1.9	2.2	2.1	1.9	1.9
North America	7.7	11.3	19.5	12.9	15.3	15.9	16.0	15.6	16.0	15.2	15.4
Of which:											
United States	7.1	10.5	18.2	11.9	14.4	15.0	15.1	14.7	15.0	14.2	14.3
Oil Exporting MENA											
MENA	4.5	4.4	2.9	4.6	9.2	7.0	6.8	7.6	8.2	7.5	6.9
Asia	4.7	6.8	9.1	11.0	11.3	13.8	15.2	16.0	16.0	19.8	21.1
Japan	8.1	13.9	14.0	16.7	11.6	12.3	12.7	12.2	11.9	11.4	11.3
European Union	65.5	48.8	44.0	43.5	40.9	40.3	39.1	39.2	38.2	36.4	36.2
Other European	3.3	1.9	1.9	4.6	4.2	3.7	3.3	3.0	3.1	3.8	3.4
Latin America	3.1	6.8	2.8	2.7	2.1	2.1	2.1	2.5	2.2	2.0	2.0
North America	4.8	11.2	21.4	12.5	16.8	17.4	17.5	16.1	16.9	15.1	15.7
Of which:											
United States	4.7	10.2	20.0	11.5	15.9	16.5	16.6	15.0	15.6	13.9	14.3
Non-oil exporting MENA											
MENA	6.3	5.4	6.7	9.0	6.5	7.5	7.7	7.4	7.0	6.5	6.2
Asia	5.5	3.9	4.0	3.9	6.1	6.8	7.1	7.2	7.5	8.2	8.8
Japan	3.2	2.7	2.6	3.1	3.5	3.6	4.2	4.2	4.1	3.5	3.7
European Union	41.2	43.0	47.0	43.7	47.8	48.1	48.3	48.6	48.1	48.1	49.3
Other European	14.6	11.6	7.0	8.3	7.8	6.9	5.2	5.3	5.4	6.4	6.5
Latin America	1.0	2.2	1.7	1.5	1.6	1.7	1.7	1.8	2.0	1.9	1.9
North America	10.6	11.6	11.8	13.9	13.2	13.6	13.7	14.9	15.0	15.3	15.1
Of which:											
United States	9.5	11.0	10.9	12.6	12.3	12.6	12.9	14.2	14.3	14.5	14.4

Table 1 (continued)
(percentage of total trade)

	1970	1975	1980	1985	1990	1991	1992	1993	1994	1995	1996
Gulf Cooperation Council											
MENA	8.9	6.2	3.9	7.1	12.3	8.3	7.8	9.0	9.5	8.4	7.5
Asia	10.4	9.9	12.5	17.2	16.4	18.9	19.8	20.9	21.3	26.5	27.6
Japan	19.2	19.6	18.4	25.7	16.7	16.7	16.9	16.3	16.1	15.1	14.8
European Union	41.4	41.1	40.2	29.6	24.0	25.9	26.1	26.2	25.2	23.3	24.7
Other European	0.7	0.2	0.6	1.4	2.3	2.9	2.5	2.9	2.7	2.5	2.2
Latin America	2.9	7.7	2.7	2.9	2.5	2.3	2.2	2.6	2.4	2.1	2.0
North America	4.9	7.0	17.6	10.4	20.7	21.0	21.0	18.3	19.2	17.3	17.4
Of which:											
United States	4.5	5.8	16.1	10.2	19.9	20.1	20.2	17.4	18.2	16.5	16.5
Arab Maghreb Union											
MENA	2.2	1.7	1.8	2.9	5.3	6.0	6.7	6.4	6.9	6.6	6.3
Asia	1.7	1.7	1.1	2.2	2.3	2.9	3.6	3.7	3.4	3.2	3.0
Japan	1.2	3.1	2.8	2.9	1.9	2.0	2.0	2.1	2.0	1.8	1.7
European Union	77.3	62.8	55.6	63.5	68.5	69.9	69.6	70.1	69.1	68.9	70.2
Other European	6.0	6.3	5.4	8.9	7.2	5.6	5.2	3.4	4.0	6.4	5.7
Latin America	2.7	4.8	2.9	2.3	1.5	1.7	1.8	2.3	2.1	1.9	2.1
North America	5.9	15.9	26.6	13.9	7.9	7.5	7.0	9.2	9.2	7.8	8.1
Of which:											
United States	5.7	15.3	25.7	11.7	6.7	6.3	6.0	7.9	7.7	6.0	6.0

1 Data for countries where information was available throughout sample period.

Source: IMF, *Direction of Trade and Statistics.*

Table 2 Intra-Regional Trade, 1970-1996
(percentage of total trade)

	1970	1975	1980	1985	1990	1991	1992	1993	1994	1995	1996
MENA	5.4	4.7	3.7	6.1	8.1	7.2	7.2	7.5	7.7	7.0	6.5
European Union	57.9	56.5	57.3	58.5	64.6	64.8	65.2	60.6	60.9	61.4	60.6
Mercosur	9.6	6.6	9.9	7.0	11.0	12.9	16.1	18.9	19.5	19.5	19.8
APEC	...	...	51.0	62.3	61.3	60.7	60.9	62.8	64.7	64.9	64.7
NAFTA	36.0	34.3	33.4	44.9	41.8	42.4	43.6	45.8	48.0	46.9	48.3
Africa	8.2	5.4	5.2	5.2	7.6	7.5	8.0	8.2	9.1	10.3	8.6
Eastern and Central Europe	33.2	36.9	41.2	35.5	25.1	21.6	22.3	25.3	32.6	34.7	36.6

1 Data for countries where information was available throughout sample period.

Source: IMF, *Direction of Trade and Statistics.*

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Floor Discussion of "Regional Integration in Africa and the Middle East"

'Natural' Integration and Sub-Regions

Several participants wondered about the 'natural' composition of regions in the Middle East and Africa. For instance, Björn Hettne asked whether it would not be more helpful to view Africa as well as the Middle East in terms of sub-regions, and Zdeněk Drábek asked, "Should we view the 21 Arab countries as a natural integration region? I understand that the language and religion issues are powerful, but are there other powerful forces that would help pull these countries together?"

Mohamed El-Erian replied, "By its nature, the definition of the region is arbitrary. The issue of which countries to include in a Middle East regional arrangement is controversial. Do you include Israel? Iran? What about Turkey? Not even the World Bank and the IMF can agree on what constitutes the Middle East. The reason I included the 21 Arab countries in my definition is because the countries themselves have indicated the desire to be treated as a region: they are all members of the Arab League, the Arab Monetary Fund, and the Arab Fund for Economic Development.

There are currently four models of regional integration in the Middle East under discussion. There is the ad hoc model which I have proposed. The second is the Gang of Four which would start with Egypt, Israel, Palestine and Jordan and then expand. The third is the EU-driven model based on the association agreements with Morocco, Tunisia, Israel, Egypt, Jordan and Syria which can be expanded to other countries. The last model is the Big Bang approach of the United States. So far, there is no inclusion problem, it is more a matter of who wants to join rather than who is allowed to join. While there is no agreement on the models, there is agreement on the principle that integration should be driven by the private sector and not based on government agreements which have negative and positive lists because that has not worked in the past.

We are optimistic. For the last two years, this region has achieved 4-5 percent economic growth, inflation is down to 10 percent and fiscal deficits are 2 percent of GDP. The macro conditions are more enabling now that a number of countries have growth rates which are higher than their inflation rates. The structural reform conditions are improving with trade liberalisation, privatisation, deregulation, and the role of the private sector is

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increasing in terms of feeding into the policy formulation process."

Ernest Aryeety answered Björn Hettne's question about sub-groupings in Africa. "To a large extent, the existing sub-regional groupings have been operating with their own institutional structures. There are various countries which have naturally become centre-pieces around which other countries revolve. In Southern Africa, for example, South Africa's immense role cannot be denied. In West Africa, there is a bit of a problem. Everyone sees Nigeria as a leading country, but it cannot play that role very efficiently until it gets its act together."

The Politics of Regional Integration in Africa

Bertil Oden had two comments on trade integration in Sub-Saharan Africa (SSA). "As Ernest Aryeety pointed out in his paper, trade integration in SSA has always been perceived as an industrialisation strategy, but in many cases it has failed. This is due in part to the import-

substitution strategy used during the 1970s, but it is also due to the fact that the assumed prerequisites of the trade integration model are met only modestly or not at all in many SSA countries. I would argue that while it is still part of an industrialisation strategy, the international context is different. Elsewhere, the primary focus is on attracting FDI by increasing the market and locking-in liberalisation efforts at the national level. In Africa, however, traditional trade integration is emphasised, and other activities are viewed basically as instruments for improving its efficiency. This is an unfortunate position because it is based on a short-term, win-lose perspective. Given the production structure and trade patterns in Africa, more attention should be given to supply-side efforts. This does not exclude trade integration, but it requires achieving a balance between investment and regional trade. In the debate about whether investment creates regional trade in the African context or regional trade creates investment and growth, I would argue that both theory and empirical evidence support the former."

With regard to specific integration arrangements in Africa, Gavin Maasdorp expressed scepticism about the establishment of an African Economic Community given the problems that a significant number of African countries face. "Countries such as the Congo, Angola and even Mozambique have to get back on some type of economic growth track. The real challenge is to put together regional arrangements like SADC based on sectoral cooperation in Africa. If your transport systems do not work, all of the trade agreements in the world will not result in significant trade integration. Malawi is already experiencing this in the context of SADC. Operators must agree on transport, telecommunication and so forth before business can be done across borders. At the same time, there is scope within the SADC region for fast-tracking – we already have it with the Southern African Customs Union and the Cross Border Initiative. In fact, when we talk about the negotiations for SADC free trade, we are talking about negotiations between two free trade areas and how to dismantle the barriers between them. An interesting point about the SADC free trade agreement is that very few of the countries have devoted any time to analysing the costs and benefits. Malawi and Mauritius are only now analysing the benefits of going into SADC free trade."

Rosalind Thomas believed that Zimbabwe and South Africa are the only two economies which are diversified enough to take advantage of any kind of industrial or manufacturing trade. "The problem in Southern Africa is development. We must seriously tackle marginalisation and the issue of integration into the global economy. When South Africa came onto the trade integration agenda of SADC in late 1994, it was confronted with a trade protocol calling for an immediate free trade agreement among all member states. Instead, South Africa advocated a phased, nuanced approach to regional integration which recognised the fact that member states in the negotiations were least-developed countries with preferences and access to differential treatment conceded to them in the WTO. It was not necessary for them to move straight to liberalisation. Furthermore, many of these SADC countries were undergoing structural adjustment programmes which made them incapable of offering a coherent regional preference among themselves. This was not open regionalism but confused regionalism.

The issue of policy credibility is closely related to this. At the September 1997 meeting, the SADC agreed to allow the Democratic Republic of Congo and Seychelles to accede. This has damaged their credibility in the region because the criteria for membership adopted in early 1995 were not used in the case of the Congo and Seychelles. South Africa opposed their accession by stating that integration was not sufficiently deep in the region to permit extra members. But in this situation, political motives were deemed more important than the policy credibility."

Samuel Wangwe stressed the link between political change and economic cooperation. "It is important to examine the influence of political change and political liberalisation on the prospects for economic cooperation in the region. South Africa's role in the region and the changes we see in the Congo are the consequences of political developments. The unfortunate developments in Burundi and the region's attempt to isolate Burundi has important implications. Not only can regional economic cooperation contribute to peace, but also the other way around, sanctions can have negative effects for economic cooperation."

Barriers and Incentives to Regional Integration

Salvatore Zecchini pointed to trade discrimination as a barrier to regional integration by comparing the Middle East with former Yugoslavia. "You would get many different answers if you asked why there is not enough competition in former Yugoslavia, but the real reason is that each individual republic views trade with the other republics as foreign trade. There is a great deal of trade discrimination which is not based on prices and market forces, but just on internal rules of origin which are not explicitly stated. I wonder whether any move toward regional integration in the Middle East would face the same kind of non-market constraints that producers face in former Yugoslavia."

Zecchini continued with an observation about the role of oil as a limiting factor in the Middle Eastern integration. "Oil has not proved to be an integrating factor in the Middle East. On the contrary, it has led to some erosion of cohesiveness in the area. In economic terms, we might say that since many of these countries had the same trade specialisation, i.e. oil, it made little sense to integrate these economies. Is this argument still valid as discouraging any move toward integration or the reduction of tariff and non-tariff barriers?"

Mohamed El-Erian replied that while oil is certainly important, it should not be overemphasised. "We have done a lot of studies on the Middle East which reveal tremendous diversity in production patterns and factor endowments, and there is scope for both inter- and intra-industry trade within the region. Certainly, we are not talking about 60 percent of regional trade as in the EU. But we are talking more along the lines of 20 percent." He went on to agree with Zecchini's comparison to former Yugoslavia. "Even if tariffs were reduced, regional trade would be inhibited by non-tariff barriers. Borders are opened and closed at the whims of politicians. And even at the open borders such as Jordan and Israel, freight has be transferred to a different truck before crossing the border."

Fred van der Kraaij suggested the importance of including informal trade in the analysis of integration in Africa. "We know that there is a lot of informal trade in Africa, both in imported products and locally produced goods. We may not know the magnitude of this trade, but I think it is an important phenomenon which should not be excluded from our analysis."

Ernest Aryeety acknowledged the importance of including informal trade in the analysis and added, "The question here is the cost at which informal trade takes place. All over Africa, you find large groups of women who travel from country to country with various goods for sale. You also find them travelling to import goods into their own country. It is even the

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dominant form of trade across borders in West Africa and now also in Central Africa, but it is not likely to grow much more than we have seen in the last two decades because of the significant costs involved. It can only grow as much as the economies grow and that is not significant now. Until some of the non-tariff barriers are removed, it will continue to exist, but it will become less prevalent than it has been."

Mohamed El-Erian confirmed that the situation in the Middle East was similar to Africa. "There is a lot of trade that escapes measurement, such as the suitcase trade like in the case of Africa and there is also border trade, but few experts think it is massive."

Jan Willem van der Kaaij wondered whether there might be other factors which have inhibited integration in the Middle East. "Mohamed El-Erian explained that the share of Middle East trade in world trade is declining, and even within that declining framework, the portion of intra-regional trade has declined. This can be the result of political tensions in the region, but those tensions have been around for a long time. Maybe there are other factors in play such as a lack of economic diversification or poor regional infrastructure. If it is the latter, perhaps it will partially be alleviated by the MENA Bank since one of its explicit missions is to facilitate and finance transborder infrastructural projects. What is the progress on its establishment?"

Mohamed El-Erian stressed the importance of institutions such as the MENA Bank in regional economic development. "The MENA bank would help overcome impediments to financing regional projects such as electricity grids, and it would also provide an important forum for the countries. It has now been established beyond doubt that this is a cost-effective use of resources – it is not a duplication of the World Bank. There is a transition team in Cairo working on it. The US will be providing 21 percent of the capital, but if the US Congress does not appropriate the funds, other countries will be much more hesitant to move. Of course, an additional problem is the Israel-Palestinian conflict."

Ernest Aryeety observed that improvement of infrastructure is also crucial in Africa. He stressed that the African Development Bank (AfDB) should be playing a much larger role. "I strongly believe that the AfDB should focus more intensively on infrastructure in Africa than it has in the past. The AfDB is fond of jumping onto international bandwagons. Today for example, micro finance is receiving attention from the World Bank and the UN, so the AfDB is investigating it as well. But the trans-West Africa highway has been on the agenda for the past 20 years, and everybody agrees that we need it. The problem with the highway is funding, and I think that this is the type of activity the AfDB should be funding."

Rosalind Thomas tied the infrastructure issue to the SADC trade proto-

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col. "Infrastructure is an important aspect of our approach to regional integration. The DBSA's (Development Bank of Southern Africa) mandate is that it has a regional role to play in SADC. We see the need for a much more holistic approach to integration rather than just trade, and infrastructure is one of these."

Samuel Wangwe added that foreign investment would be another important ingredient for African integration. "In recent years, South Africa has increased investments in neighbouring countries and it would be interesting to examine the implications of this development for regional integration in Southern Africa, particularly in light of the broadening of DBSA's mandate to include more countries of the region."

Bertil Oden warned about the volatility of short-term capital inflows. "Africa is the last non-exploited market for capital, which means that mutual funds will sooner or later go into Africa as emerging markets. This brings the issue of instability to the surface because in Africa – also in South Africa as we have seen recently – there is enormous sensitivity to the withdrawal of short-term capital."

Stephany Griffith-Jones elaborated on Oden's observation by distinguishing between different types of capital flows. "I sense that SSA countries are keen on attracting all kinds of flows because they have been starved of flows in the past, but I think there should be more emphasis on attracting long-term flows and especially foreign direct investment (FDI) which is accompanied by valuable technology transfer and know-how. Recent research reveals that the long-term macroeconomic record within Africa determines the amount of long-term flows countries attract. An additional point is that Africa faces a negative bias. This may be due to prejudice or a bad image, but it is also caused by the large number of small countries. In this internationalised world, it is expensive to collect information on every country's economy, so this is another argument for integration because it will help attract more private flows."

Ernest Aryeety pointed out that African countries are seeking considerable growth in FDI, but that macroeconomic stability has not proven to be the entire solution. "There are a significant number of African countries that have worked very hard over the last decade to achieve the kind of environment that was supposed to attract FDI. Ghana has had a stable macroeconomic regime for seven years but the investment has not yet materialised. Perceptions about African markets still have to change."

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Part V

Regionalism and Multilateralism: The Debate Reviewed

The New Regionalism: Security and Development

Björn Hettne

I Globalism versus Regionalism

Globalisation is the latest fashion among social scientists and, increasingly, outside the academic sphere. While there is little consensus about what globalisation means, there is a clear need for the concept since the level of transnational integration is qualitatively new.

Globalism, an ideology, can be defined as programmatic globalisation; a vision of a borderless world organised mainly through the market principle. *Globalisation*, a process which may have largely negative or positive connotations depending on one's normative view, was first made possible by the political stability of the American hegemonic world order, which lasted from the end of the Second World War until the late 1960s or early 1970s. Globalisation implies a deepening of the internationalisation process, a strengthening of the functional dimension of development and weakening of the territorial dimension of development. Based on this, one could argue that the process reached a new stage in the post-WWII era even though the origins of globalisation may be traced far back in history. I see globalisation as a qualitatively new phenomenon. Some speak of 'the end of history' implying a systemic convergence among various parts of the world which are also becoming increasingly interdependent. The subjective sense of geographical distance has also changed dramatically, thus prompting others to speak not only of the end of history, but also of 'the end of geography'. Simply put, there is not much left over from the territorially organised Westphalian Old World.

Globalisation basically implies the growth of a functional world market that increasingly penetrates and dominates the 'national' economies which, in the process, are bound to lose much of their 'nationness'. The economy is delinked from culture and politics, both of which are becoming intrinsically mixed in the new 'polities of identity'. While people develop micro-solidarities, the states are becoming promoters of global economic forces rather than protectors of their own populations and cultures against these demanding changes. This implies that the state is becoming alienated from civil society (civil society is defined as inclusive institutions which facilitate societal dialogue across various social and cultural borders). Furthermore,

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identities and loyalties are transferred from the civil society to primary groups which compete for territorial control, resources and security. This is a morbid replay of the 19th Century Westphalian logic, and the contradictions involved may result in a collapse of organised society.

For this reason, some observers think or hope that a political counter movement will eventually emerge to modify, halt or reverse the process of globalisation in order to safeguard some degree of territoriality, civic norms, cultural diversity, and human security – principles that we associate with civilised society. One rather radical way of achieving such a reversal of trends, i.e. *de-globalisation*, could be through regionalisation as a neo-mercantilist political project, i.e. the building of (supra-national) regional communities. The regionalist response can take different forms depending on the interests of the dominant actors. If globalisation can be seen as a 'first movement' in a second Great Transformation (à la Polanyi), a neo-mercantilist form of regionalisation may form part of a 'second movement' together with other forms of resistance to globalisation.

The two processes of globalisation and regionalisation can thus be articulated within the same larger process of global structural transformation, the outcome of which depends on a dialectical rather than linear development; it cannot be readily extrapolated or easily foreseen. Instead, it expresses the relative strength of contending social forces involved in the two processes which deeply affect the stability of the traditional Westphalian state system. Therefore they contribute to both order and disorder and, possibly, a future post-Westphalian world order of some sort. By 'Westphalian system', I mean an interstate system of sovereign states and the particular political logic that characterises each individual state. The state is comprised of citizens with obligations and rights defined by citizenship and allegiance to the nation-state, and the outside world is conceived as anarchy, with neither rights nor obligations. Post-Westphalian rationality, on the other hand, would assert that the nation-state has lost its usefulness, and that solutions to problems of security and welfare must be found in different forms of transnational structures, i.e. multilateral or, as this paper argues, regional. By maintaining the territorial focus and the emphasis on the role of 'the political', a 'regionalised' world can be said to constitute a compromise between Westphalian and post-Westphalian rationalities.

The Westphalian order took shape during the modern phase in European history, roughly starting with the peace of Westphalia (1648). The lengthy state-building process in Europe was a violent one and people gradually learned to view their own state as a protector and the rest of the world as an anarchy and a threat to their security. In the post-colonial era, state-building became a global process and the nation-state became a uni-

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versal political phenomenon. The Westphalian rationality takes a particular nation-state as the given guarantee for security as well as for welfare. The identity of the security of the citizens and the security of the state is taken for granted. The turbulence and uncertainties many people experience today come with the unpleasant realisation that this guarantee, historically associated with the status as citizen of a state, can no longer be taken for granted. Increasing numbers of people are international refugees without citizen rights or a floating domestic population without substantive rights and unwelcome everywhere.

The awkward situation sketched above raises the question of how basic security as a human need can be maintained in a world of eroding nation-state structures. Are there structures emerging to compensate for the transforming, if not vanishing, nation-state?

II The New Regionalism

Over the last decade, regionalism has 'been brought back in', albeit in a different form compared to three decades ago. There is a 'new regionalism' or, more correctly, there are 'new regionalisms'. Consequently, there are many definitions of the new regionalism and, as with globalism, there are critics and supporters. The critics view the regionalist trend as a threat to the multilateral system and a violation of the ideal of United Nations (UN) multilateralism. The supporters think that the new regionalism might form the basis for an improved multilateral system, including a better deal for the poor regions. I argue that we are dealing with a 'new' regionalism which is largely a political response to the market-driven process of globalisation and the social eruptions associated with it. I pay particularly attention to what happens to the South in the overall process of globalisation and regionalisation.

In my view, the basic problem with globalisation is that it is uneven and selective. Exclusion is inherent in the process, and the benefits for some are evenly balanced by misery, conflict and violence for others. Some observers refer to a zone of conflict in contrast with the stable and well-functioning zone of peace. It is in this way that a new Third World appears to be emerging, characterised by poverty and violence. These negative features are incompatible with civil society and thus, in the longer run, pose a threat to all humanity.

The new regionalism can be looked at in many different ways, but usually the focus is limited to its effects on regional and global trade. Regionalism and multilateralism have thus been compared in terms of their contribution to effectiveness in promoting free trade and maximising

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world welfare. On the other hand, our approach in the WIDER project on the New Regionalism suggests that regionalism can achieve many more objectives. We also make a very strong distinction between the current trend of regionalism, since about 1985, and what went before. The new regionalism differs from the 'old' regionalism in a number of ways, and I want to emphasise the following five:

1. Whereas the old regionalism was formed in a bipolar Cold War context, the new regionalism is taking shape in a multipolar world order. New regionalism and multipolarity are, in fact, two sides of the same coin. The decline of US hegemony and the breakdown of the communist subsystem created room-for-manoeuvre in which the new regionalism could develop. It would never have been compatible with the Cold War system since the quasi-regions of that system tended to reproduce bipolarity within themselves, thereby creating artificial and mutually hostile sub-regions. The First World constituted one pole, the Second World constituted the other, and both struggled for hegemony in the old Third World. This pattern of hegemonic regionalism was discernible in all world regions at the height of the Cold War, but most clearly in Europe and East Asia. Today these types of gaps are closing, perhaps to be replaced by others. There are, however, still remnants of the Cold War order in East Asia.

2. Whereas the old regionalism was created 'from above' (often through superpower intervention with the purpose of alliance building), the new is a more spontaneous process from within the regions where the constituent states experience the 'urge to merge' in order to tackle new global challenges, as well as domestic problems. Regionalism can be understood partly as a reaction to the consequences of globalisation, and both regionalisation and globalisation form part of the current world transformation. Since most states lack the capacity and the means to manage global transformation on the national level, regionalism is one way of coping with the task. This is particularly obvious in the peripheral regions where regionalism has become a major strategy to achieve security and development.

3. Whereas in economic terms the old regionalism was inward-oriented and protectionist (often associated with import-substitution industrialisation), the new is often described as 'open' and thus compatible with an interdependent world economy. The idea of a certain degree of preferential treatment of and solidarity among countries within the region is, nevertheless, implied in the idea of open regionalism. How this some-

what contradictory balance between the principle of multilateralism and the more particularistic regionalist concerns shall be maintained remains somewhat unclear. I would rather stress the ambiguity between 'open' and 'closed' regionalism which is marked in the intermediate regions which aspire to Core status.

4. Whereas the old regionalism was specific with regard to its objectives (some organisations being primarily security motivated, others economically oriented), the new is a more comprehensive, multidimensional process. This process includes not only trade and economic development, but issues such as the environment, social policy, and security; these serve to push countries and communities towards cooperation within new types of regionalist frameworks. Since the economic differences may be large in otherwise culturally coherent regions, a North-South dimension is entering the regionalisation process.

5. Whereas the old regionalism was only concerned with relations between nation-states, the new is part of a global structural transformation process in which also non-state actors (many different types of institutions, organisations and movements) are active and operating at various levels of the global system. As such, the global system is increasingly structured by the new regionalism which actually makes up different regionalisms in the Core, in the Intermediate regions, and in the Peripheral regions.

The new regionalism, I suggest, includes economic, political, social and cultural aspects, and goes far beyond free trade arrangements. Instead, the political ambition of establishing regional coherence and regional identity – apart from security and welfare – seems to be of primary importance. This 'pursuit of regionness' can be compared to 'the pursuit of stateness' in classic mercantilist nation-building.

Five levels or stages of regionness can be distinguished. The first two stages refer to the potential formation of a region. Actual regionalisation happens in stage three, whereas stages four and five represent higher forms of regionalisation formations such as the EU (the only one so far). So when we speak of regions, we actually mean regions in the making.

The regionalisation process can be intentional or non-intentional and may proceed unevenly along the various dimensions of the 'new regionalism', i.e. economic (including development regionalism), political (including security regionalism), social and cultural. In this paper, I focus on intentional regionness along the dimensions of security and development.

The five levels of regionness are:

1. *Region as a geographical unit*, delimited by more or less natural physical barriers and ecological characteristics: Europe from the Atlantic to the Ural, Africa South of Sahara, Central Asia or the Indian subcontinent. This first level can be referred to as a proto-region, or a pre-regional zone since there is no organised international society. In order to regionalise further, this particular territory must, necessarily, be inhabited by human beings maintaining some kind of trans-local relationship. This brings us to the social dimension which is the real starting point for the regionalisation process.

2. *Region as a social system* implies ever widening trans-local relations between human groups. Such relations of embryonic interdependence constitute a security complex in which the constituent units are dependent on each other as well as on the overall stability of the regional system. Thus, the existing social relations may very well be hostile and completely lacking in cooperation. Just like the larger international system of which it is a part, the region can be described as anarchic at this level of regionness. The classic case of such a regional order is 19th century Europe. At this low level of regionness, a balance of power or some kind of 'concert' is the sole security guarantee – which is a rather primitive security mechanism. Similarly, the exchange system tends to be based on symbolic or kinship bonds rather than trust. We could therefore talk of a primitive region exemplified, as far as security is concerned, by the Balkans today and, in spite of a high degree of spontaneous economic integration, by East Asia.

3. *Region as transnational cooperation* can be explicitly organised or emerge more spontaneously and informally. It can include any of the cultural, economic, political or military fields and any combination of these. In the case of more organised cooperation, region is defined by the list of countries which are the formal members of the regional organisation in question. The more organised region could be called the 'formal' region. In order to assess the relevance and future potential of a particular regional organisation, the 'formal' region (defined by organisational membership) should be related to the 'real region' (defined in terms of potentialities, convergencies and through less precise criteria). This is the stage where the crucial regionalisation process occurs. The dynamics of this process can be described as a convergence along several dimensions – economic as well as political and cultural.

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4. *Region as civil society* takes shape when an enduring organisational framework (formal or less formal) facilitates and promotes social communication and convergence of values and actions throughout the region. Of course the pre-existence of a shared cultural tradition in a particular region is crucially important at this stage, particularly for more informal forms of regional cooperation, but culture is continuously created and recreated. Nevertheless, the defining element is the multidimensional and voluntary quality of regional cooperation. In terms of society, the region can be defined as an emerging regional anarchic society which is something more than anarchy but less than society. In security terms, the obvious reference is to security community.

5. *Region as acting subject* with a distinct identity, actor capability, legitimacy and structure of decisionmaking. Crucial areas for regional intervention are organised conflict resolution (between and particularly within former 'states') and creation of welfare (in terms of social security and regional balance). This process is similar to state-formation and nation-building, and the ultimate outcome could be a 'region-state' which is comparable to the classical empires in terms of scope and cultural heterogeneity. In terms of political order, this 'region-state' constitutes a voluntary evolution of a group of formerly sovereign national, political units into a supra-national security community where sovereignty is pooled for the good of all. This is essentially the idea of the European Union as outlined in the treaty of Maastricht, though the gap between idea and reality is still quite large. This fifth form of region is still a notion for the future – certainly outside Europe but, as it now appears, inside Europe as well. It is important to note that at this stage of regionalisation, conflict resolution implies the existence of institutions and mechanisms, and not the ad hoc interventions of the type that occur today. These attempts at crisis management serve to underline the need for more institutional forms of conflict resolution at the regional level.

These five levels (or stages) may suggest a certain evolutionary logic. However, the intention is not to suggest a stage theory, but simply to provide a framework for comparative analysis of emerging regions. Since regionalism is a political project devised by human actors, it may – just like a nation-state project – fail. For instance, the Amsterdam summit in June 1997 was a failure for the European project (how big a failure remains to be seen). This failure, in turn, means decreasing regionness and peripheralisation for the region concerned. Thus, changes in regionness imply changes of the structural position in the centre-periphery order. A region in decline means decreasing regionness and, ultimately, a dissolution of the region itself. The obvious reference here is to the peripheral regions in the New Third World. The struggle against peripheralisation is the struggle for increasing regionness, from the very low level of a potential or primitive region. We shall return to this more activist dimension towards the end of the paper.

The new regionalism is linked to globalisation in different ways, and can therefore not be understood merely from the point of view of the single region in question – whether it be Southeast Asia, South Asia, Southern Africa or the Southern Cone of Latin America. Rather, it should be defined as a world order concept since any particular process of regionalisation in any part of the world has systemic repercussions in other regions, thus shaping the way in which the new world order is being organised.

While the emerging global power structure will be defined by the world regions, they will be very different types of regions. To clarify this pattern, I shall rely upon dependency theory and its familiar division of the world system into Centre (or Core) and Periphery. However, today's dependency analysis takes place at a stage of higher integration and interdependence of the world than two or three decades ago. Consequently, the 'delinking' option is ruled out in any other way than in the form of involuntary marginalisation.

III Regionalism and Global Structure

In spite of the current wave of post-structuralist thinking in International Relations Theory, it still makes sense to conceptualise the world as a structural system, i.e. a system defined by certain regularities and rigidities in relations among its constituent units. What is new about the system today is that as a consequence of transnationalisation processes, various structural positions can increasingly be defined in terms of regions rather than nation-states. This makes it important to understand the nature of the emerging regional formations in the North and in the South.

A distinction can be made between three structurally different types of regions: Core regions, Intermediate regions and Peripheral regions. There are also two basic characteristics which distinguish the regions: their relative degree of economic dynamism and their relative political stability.

- The *Core regions* are economically more advanced and normally growing and they have stable – if not always democratic – regimes which manage to avoid inter-state as well as intra-state conflicts. They organise for the sake of being better able to control and gain access to the world outside their own region. One important means of control is ideological hegemony. The predominant economic philosophy in the Core is currently neoliberalism which is also, with varying degrees of conviction, preached throughout the world. As has always been the case, the stronger economies demand access to the less developed in the name of free trade. We can thus speak of neoliberal regionalism although it may sound like a contradiction in terms. This is the 'stepping stone' (rather than 'stumbling block') interpretation of regionalism with respect to its relation to globalisation. There are, however, different emphases among the core regions, and these differences may become more important depending on which type of capitalism is more viable in the longer run. Three forms of capitalism are commonly referred to: the unregulated capitalism of North America, the administered capitalism of East Asia, and the social capitalism of Europe.

- The *Intermediate regions* are, at present, closely linked to a Core region in the sense that they have strong economic relations with a particular Core region and try to pursue similar economic policies. Thus, they will gradually be incorporated into the Core as soon as they fully conform to the criteria of 'coreness', i.e. sustained economic development and political stability. While the 'politics of distribution' characteristic of social capitalism has probably been thrown in the historical dustbin, the praise for free trade is nevertheless somewhat more reserved. The prevalent expression in both Southeast Asia and Latin America is 'open regionalism' which in practice means open economies with some preference for one's own region as well as a rather precautionary attitude towards the Core regions and their assumed adherence to free trade.

- The *Peripheral regions*, in contrast, are politically turbulent and economically stagnant. War, domestic unrest, and underdevelopment constitute a vicious circle which plunges them to the bottom of the system (creating a zone of war and starvation). They have to organise in order to arrest a threatening process of marginalisation and complete collapse. But their regional arrangements are as fragile and ineffective as their state structures and civil institutions. This weakness notwithstanding, they must first tackle acute domestic violence and poverty. Their overall situation makes 'security regionalism' and 'developmental regionalism' more critical than the somewhat irrelevant creation of free trade regimes, or even adherence to the more cautious 'open regionalism'. They have objective reasons to be more introverted and more interventionist than they are allowed under the present hegemonic order and economic ideology. This tendency is what lies behind the protectionist (stumbling block) interpretation of the new regionalism.

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Let us now look at these structural positions in more empirical terms by placing the concrete regional formations in the three structures. There are three politically capable Core regions. So far only one of the three Core regions, Europe, aspires to build a formal political organisation. Europe is the paradigm of regionalisation, and it serves both as a model (stimulating other regions to become more integrated) and a threat (provoking other regions to be prepared for a protectionist turn in the world economy). As a model, the EU appears increasingly less impressive as the convergences are ebbing out. Even though it is true that the single market is a fact and the monetary union has been given highest priority, a joint defence identity still seems to be a fairly distant dream. The third pillar (interior affairs) is slowly beginning to be erected. The enlargement towards Central Europe will most likely be delayed, which shows a general lack of deeper concern among the states for overall stability and peace in Europe. The process of regional integration is slowing down and neo-nationalism is rising. The latest experience, the Amsterdam summit in June 1997, was not very encouraging. However, there is no change in the general direction so far and, as has been the case before, further cooperation will occur only when it becomes necessary.

The other two Core regions, North America and East Asia, are both economically strong, but they still lack a regional political order. This is particularly true and dangerous for East Asia where serious tensions between nation-states are just below the surface. In terms of security, the whole region is an enormous vacuum. It is marked by a rather low level of regionness, although this is compensated for by an increasingly dense economic network. East Asian regionalism is often described as *de facto* regionalism whereas regionalisation is presumed to occur *de jure* in Europe and, to a lesser extent, North America. This contrast may be due to differences in political culture, but an alternative explanation might be that East Asian inter-state relations are rather tense and unsettled (albeit not openly hostile). Thus, a growing maturity of the regional security complex may lead to a more formal regionalism, just as the normalisation of relations among the countries in Southeast Asia has been accompanied by a more formal and predictable (de jure) regional arrangement than seems to be possible in East Asia. Having said this, it is obvious that on levels other than the inter-state level, there has been an impressive process of regionalisation. The future of the region is either very bleak – in case the potential conflicts are translated into open conflict and war – or very bright – if the degree of economic interdependence proves to be a point of convergence of interests where every state acquires an ever stronger stake in stable peace.

As far as NAFTA is concerned, the US has a more dynamic economy than Europe. It represents a model of neoliberal capitalism that Europeans

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refer to as the 'American model'. On the other hand, the region is threatened by social upheaval as the neoliberal doctrine is translated into growing geographic, social and ethnic cleavages. There has been guerilla fighting in two Mexican states, Chiapas and Guerrero. In the US, there are internal low-intensive social wars going on in the big cities. And in Canada, national identity is being reformulated and transferred from the federal to the provincial level suggesting that the very integrity of the Canadian nation is endangered. Thus, even in the Core itself there are problems on the social and political front in spite of the fact that the economies (as if they would be separated from society) are said to be in excellent shape.

Structurally close to the Core are the Intermediate regions which are preparing for incorporation into the Core. The speed of incorporation depends on their continuous good 'core-like' behaviour. This implies maintaining economic growth in a context of openness and deregulation as well as eliminating and, if necessary, repressing domestic conflicts. Until recently, ASEAN provided a good example of successful handling of these imperatives but as events show, no situation is stable. Consequently, there may be dramatic changes in terms of structural position, so what is suggested here is only a tentative map of the new regionalised world.

There are seven Intermediate regions:

- Central Europe, obediently waiting in the first line for membership into the European Union. In this line are the Czech Republic, Poland and Hungary. There is a big question mark for Slovakia. This group has been joined by Slovenia, having escaped from the Balkan imbroglio, which is behaving exceedingly well as an exemplary Central European candidate to EU membership. Croatia intends to follow a similar route, but it is held back due to its miserable human rights record. It will most probably remain in the Balkans in the foreseeable future. The Baltic countries also belong here as they escape the post-Soviet area and make a decisive turn to the West. Estonia has shown the way.
- Latin America and the Caribbean, now in the process of becoming 'North Americanised', but with an important southern bloc, Mercosur, which puts up some resistance to the neoliberal logic, and will presumably become more defensive about Latin culture. The future relationship between NAFTA and Mercosur is crucial but difficult to foresee.
- Southeast Asia, primarily the original ASEAN countries, repeating the development pattern of East Asia to which it is increasingly linked economically as well as in security terms.
- The European Pacific (Australia, New Zealand) and possibly South

Pacific (organised in the South Pacific Forum), all now being drawn by Japanese capital into the larger East Asia economic space. The South Pacific has seen some turbulence lately and may also sink into the Periphery.

- Coastal China, following in the footsteps of Southeast Asia and, together with Hong Kong and Taiwan, becoming part of a Greater China subregion.
- Southern Africa, or part thereof, has the potential of becoming an Intermediate region after an impressive record of conflict resolution. However, this is under the condition that South Africa plays the role of benevolent regional hegemon and becomes the engine of economic development as well as the guardian of regional peace. This remains to be seen, but a start has been made at least.
- North Africa, also a potential candidate, but unfortunately about to sink into the periphery due to the domestic unrest in Algeria (with spill-over risks). It is necessary to put an end to this destructive process in order to avoid sinking further into the periphery. The question is how this should be done without further violence and polarisation.

Remaining in the Periphery are the following seven regions or sub-regions:

- The post-Soviet area, where the major parts of it (with the exception of the Baltic region) are now in the process of being reintegrated in the form of a Commonwealth of Independent States (CIS), perhaps laying the foundation for a future core region. This large area is not homogenous. Central Asia is more peripheral than the western part of the former Soviet Union, and there is little likelihood that it will stick together unless a new empire of the old type is formed. Major changes can be expected as far as new alignments are concerned.
- The Balkans, where the countries have lost whatever little tradition of cooperation they once might have had. This is a region which can only be defined as an explosive regional security complex. The current degree of regionness in the Balkans is low indeed. One can speak of a geographical region and a regional security complex (with high security interdependence), but there is no formal regionalism, there are only a few spontaneous regional activities. The Balkans is certainly not a regional civil society and it is far from being an actor in its own right and with its own agenda.
- The Middle East, a region originally defined from outside and with a most unsettled and very explosive regional structure. The states are heterogenous and incoherent, and they compete for regional hegemony. The level of regionness is low, and to the extent that a stronger regional

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identity will emerge, it will be confined to various sub-regions.

- South Asia, in spite of SAARC, has shown a very low level of 'regionness' because of domestic violence and the 'cold war' between the two major powers, India and Pakistan. To the extent that this hostility can be overcome (and such attempts are now being made), the region may quickly reach intermediate status, but probably at the cost of new internal divisions.
- The former Indochina sub-region of Southeast Asia together with Burma, all on their way to ASEAN membership in spite of their economic and political problems. Like the southern enlargement of EU, this may stabilise the whole region. Even these additional states, foremost among them Vietnam, could eventually reach intermediate status. Cambodia remains a big question mark.
- Inland China has not been part of the modernisation process, and it is lagging far behind the rest of China. This may endanger the coherence of the Chinese state/empire and destabilise the intermediate Chinese region as well.
- The rest of Sub-Saharan Africa, particularly Central Africa and the Horn of Africa, where the political structures called 'states' are falling apart in many countries. As noted above, South Africa along with a substantial part of the Southern African region may emerge as an Intermediate region. Similar potential exists in West Africa where Nigeria, for various reasons, keeps the regional peace but is itself politically divided and internationally isolated.

Thus, the Peripheral regions are 'peripheral' because they are economically stagnant, politically turbulent and war-prone. This is not an explanation of their status, it is merely a structural analysis of their relative positions in the world system. Underdevelopment generates conflict, and conflict prevents necessary steps for improving the economy. To the extent that the structural criteria are transformed by purposive state action, the region 'moves' from one structural position to another. The exact borders of this 'new' Third World are impossible to draw, and the dividing line sometimes goes through large countries (China, India, Brazil). It seems likely that attempts to reach intermediate status by linking up to the world market will lead to deeper internal divisions with destabilising consequences. There are also cases where individual countries are lingering between two structural positions (Slovakia, Ukraine, Peru, Vietnam).

The only way for these poor and violent regions to become less peripheral in structural terms is to become more regionalised, i.e. to increase their levels of 'regionness'. Their only other power resource would rest in their capacity to create problems for the core regions ('chaos power'),

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thereby inviting or provoking some sort of external engagement. This mechanism can be seen in Southern Europe's concern for North Africa, Central Europe's concern for Eastern and Southeastern Europe and Russia and Scandinavia's concern for the Baltics. It can also be seen in the growing emphasis that the Chinese (PRC) authorities place on spreading some of the economic dynamics from east and south to west and north. They hope to avoid the invasion of the prosperous areas by desperate paupers, the so-called floating population of perhaps one hundred million fleeing the nameless misery of interior China. Nothing can more drastically illustrate the delinking of 'peripherality' from territory in the new world order.

IV The Dynamics of Regionalisation

The degree of 'regionness' of particular areas can increase or decrease depending on regional dynamics in which global as well as national/local forces have an impact. Regionalisation affects and is affected by many levels of the world system: the system as a whole, the level of inter-regional relations, and the internal structure of the single region, including inter-state relations. It is not possible to state which of these levels comes first or which is more important since changes which take place on the various levels of the world system interact. Together these interactions define the dynamics of regionalisation.

There are also different dimensions of the process which relate to each other. Regional integration was traditionally seen as a harmonisation of trade policies leading to deeper economic integration with political integration as a possible future result. The new concept of 'new regionalism' refers to a transformation of a particular region from relative heterogeneity to increased homogeneity with regard to a number of dimensions, the most important being culture, security, economic policies and political regimes. The convergence along these four dimensions may be a natural process, it may be politically steered or, most likely, it will be a mixture of the two. A certain level of 'sameness' is a necessary but not sufficient condition for this new form of regional integration.

- Culture takes a long time to change. Important in this sense is the inherently shared culture which is usually transnational since national borders are artificial divisions of a larger cultural area in many cases.
- A transformation of the security regime (from security complex toward security community) is perhaps the most crucial factor.
- Changes in political regimes today typically mean democratisation.
- Changes in economic policies nowadays normally occur in the direction

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of economic openness.

The interaction between these dimensions make up the dynamics of regionalisation. Furthermore, these dynamics can be found at different levels of world society:

- On the global level, the changing structure of the world system towards fragmentisation provides room-for-manoeuvre for the various regional actors. At the same time, the process of regionalisation in the form of higher regionness of various regional formations constitutes a structural change towards multipolarity.
- On the level of inter-regional relations, the behaviour of one region affects the behaviour of others. For instance, European regionalism is the trigger of global regionalisation in at least two ways: one positive (in promoting regionalism by providing a model) and one negative (in provoking regionalism by constituting a protectionist threat).
- The regions themselves constitute arenas for sometimes competing, sometimes converging 'national interests' with the nation-states as dominant actors. If the overall trend within a particular geographical area is convergence of interests, we can speak of an emerging regional actor.
- The actual process of regionalisation is triggered by events on the sub-national level as well. One example is the 'black hole' syndrome, i.e. the disintegration of nation-states due to ethno-national mobilisation. A less violent form of national disintegration is the emergence of economic micro-regions as the geopolitical environment creates a more direct access to the macroeconomy for dynamic sub-national regions.

Although the region is slowly becoming an actor in its own terms, the nation-states typically still conceive it as an arena where national interests could be promoted; these interests are, of course, conceived differently by different social groups in society. Whereas certain groups may find it rewarding to move into the supra-national space, others cling to the national space where they have their vested interests to protect. Regionalisation thus creates its own counter forces.

V The Crucial Role of State Behaviour

Regionalisation does not occur unless the states in a particular region desire it. It may come about through a spontaneous or unintended convergence in terms of political regime, economic policy or security, but often one can identify a triggering political event which sets the process in motion. Naturally, this political event is related to the main players in the region, the policymakers, as distinguished from policytakers, i.e. the small-

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er players. In order to understand the regionalisation in various areas of the world, it is useful to observe the behaviour of the policymakers, i.e. the dominant states.

We can divide the policymakers into two categories, those whose influence goes beyond a particular region (the world powers) and those whose influence is confined to a particular region (the regional powers). World powers may not be able to achieve hegemony on the world level and since the range of their influence is undefined and varying, this means that there will be a certain amount of competition among them. The regional powers may be hegemonic in their own regions (which implies a general acceptance or at least tolerance of their leadership throughout the region), or simply dominant (which means that they are looked upon with suspicion and fear among the minor players).

The policytakers can be further subdivided into:

- the supporters who are supportive of the regionalisation process (sometimes the smaller players are the main proponents);
- the multi-trackers who try to find their own path or, rather, several paths since they would be welcome into more than one regional organisation;
- the isolated who are left in the cold since they are seen as liabilities rather than assets (for instance Peru, Burma, North Korea). However, they cannot be made to disappear. They still have the power of provoking regional security crises through domestic turbulence, by being black holes in need of external intervention.

In some cases regionalism grows from extended bilateral relations, for instance in the Americas, where both NAFTA and Mercosur resulted from a situation where third parties (Canada and Uruguay) became anxious not to be left out in the cold. The regional powers (in these cases US and Brazil) usually prefer bilateralism to regionalism. This is also the case in South Asia where the small players softly imposed regionalism on the regional power India, which was always more in favour of bilateralism. China seems to be repeating the same role in East Asia.

Thus, the change from bilateralism to regionalism is one crucial indicator of increasing regionness, but as defined here, increasing regionness can also result from overlapping bilateral agreements within a region since such agreements imply policy convergences in various fields. It is therefore important to take the geographical area as the point of departure instead of the formal regional agreements. Regions are typically 'regions in the making' rather than distinct regional formations.

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VI Security and Development Regionalism

So far I have dealt with the structural pattern of a regionalised world order. The definition of this pattern in terms of established and repeated behaviour among states and other actors is made intentionally to avoid the image of a structural trap, which characterised much of earlier dependency theory. A behavioural change thus implies also structural change. The structural problems are to a large extent internal to the region and can be dealt with by changed policies in the various states, but it must be a change in the same direction among a group of neighbouring countries, i.e. what has been referred to as regionness. Let me therefore turn to the problem of purposive change of structural positions, through the help of regional cooperation and integration. The issue I want to discuss concerns the strategic value for various actors of a conscious regionalisation policy in terms of security and development. I will confine my brief analysis to states in the peripheral areas, or what may be said to constitute the 'new' Third World. Violence and underdevelopment are the two problems which define these peripheral areas.

Security Regionalism

Security regionalism can be defined as attempts by the states in a particular geographical area – a region in the making – to transform a security complex with conflict-generating interstate relations towards a security community with cooperative relations. Increasing regionness in a regional security complex is manifested in an increasing role for regional interventions rather than either extra-regional (multilateral or plurilateral) or intra-regional (unilateral or bilateral). Of course, if we are dealing with a security community, the issue of external intervention in a failed state does not arise. This is the highest level of regionness along the security dimension.

What are the security problems to which regionalisation may provide a solution? They can be summarised in the metaphor of 'black holes', or what in UN terminology is referred to as 'failed states'. These constitute a problem for neighbouring states who rely on a stable regional environment for their international credibility, and who are prone to intervene if something goes wrong in one particular state. Nigeria thus takes an interest in stabilising the West African region in spite of being rather shaky itself. And, if need be, Brazil will explain to the military in Paraguay that coups will not be accepted in the new era of Mercosur cooperation. National disintegration seems to reinforce the process of regionalisation via threats to regional security provoking some kind of reaction on the regional level. National disintegration may even be said to form part of the process of regionalisa-

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tion since the enlargement of political space provides opportunities for different sub-national and micro-regional forces, previously locked into state structures, to reassert themselves in peaceful (as in the case of micro-regionalism) or violent (as in the case of ethno-nationalism) ways.

In relation to the earlier discussion of the undermining effect of globalisation on the Westphalian state system and the internal legitimacy of weak state formations, the collapse of political authority at one level of society (the nation-state) tends to open up a previously latent power struggle at lower (sub-national) levels. In such a complex multiethnic polity, the process of disintegration may continue almost indefinitely. But only 'almost'. The world does not like a vacuum. Sooner or later there must be some reorganisation of social power and political authority on a higher (transnational) level of societal organisation – most probably the region. Why? Because most wars today are civil wars, and a region facing a Hobbesian situation in one of its states must provide some substitute for the vanishing state authority. The threat as such makes the region an actor whether it likes it or not.

This more permanent regional arrangement is, however, likely to be preceded by some form of external intervention with the purpose of reversing the disintegration process which threatens to become a regional security crisis. Again the region may play a role as an actor, but there are also other, and so far more important, actors. In making an inventory of possible actors, we can distinguish between five different modes of external intervention in regional security crises: unilateral, bilateral, plurilateral, regional and multilateral.

- Unilateral intervention can either be carried out by a concerned neighbour, for instance trying to avoid a wave of refugees, or by a regional power or superpower which has strategic interests in the region. The numerous US interventions in Central America are the most obvious case in point. Regarding neighbourly interventions such as Tanzania's in Uganda and Vietnam's in Cambodia, it is interesting to remember that they were highly controversial in spite of the fact that there might have been good reasons behind them.
- In the bilateral case there is some kind of (more or less voluntary) agreement between the intervener and the country in which the intervention is made. One such rather unusual case was India's intervention in Sri Lanka's civil war.
- The plurilateral variety can be an ad hoc group of countries or some more permanent form of non-territorial alliance such as NATO or the Islamic Conference. The intervention in Bosnia was multilateral (UN) as well as regional (EU), but the more effective interventions were plurilateral.

- Regional intervention is carried out by a regional organisation which has a territorial orientation. One such rather unexpected intervention was the ECOMOG force in Liberia, organised within the framework of ECOWAS.
- Multilateral intervention normally means a UN-led or at least UN-sanctioned operation. The most spectacular operation of this type so far was the one in Cambodia. The operation allowed Japan, which has a far-reaching security interest, the opportunity to participate in a large international action. For Cambodia, several questions remain, above all how and on what conditions the Khmer Rouge may rejoin the national community. Only when this problem has been resolved, will it be possible to talk about real conflict resolution. So far this is rather a case of multilateral conflict management with a strong regional component as a result of Japanese involvement and the strong ASEAN interest in regional peace.

These distinctions are not very clear-cut, and in real world situations several actors at different levels may be involved; the number usually increases with the complexity of the conflict itself. However, I believe that future external interventions will prove to be a combination of regional and multilateral operations, but with an increasingly important role for the former. Unilateral action lacks legitimacy and raises suspicion in the international community. Bilateral action such as the Indian intervention in Sri Lanka could, were it not for India's persistent bilateralism, have been organised as a regional, i.e. a SAARC operation. This would presumably have made it more legitimate. In cases where there are sleeping regional organisations, such as the case of ECOWAS in West Africa, they may be revived and even find a new task for themselves as a result of a regional crisis. Even when there are no regional organisations at all, regional initiatives (however feeble) are nevertheless taken. The legitimacy of such actions rests merely in the fact that no organised actor with sufficient legitimacy is prepared to get involved. This may, however, be a security imperative for neighbouring states since inactivity may spell their own undoing. This also suggests a stronger regional interest in a durable solution. For a multilateral or plurilateral force, the intervention is a task with a definite end (the soldiers move out), but for regional actors the problem remains unless it is solved in a more comprehensive way. A regional solution must be embedded into the larger regional power structure. A cease-fire is not enough. A stable solution demands the building of a regional security community.

The record of regional intervention in domestic conflicts and regional conflict resolution is a recent one, and therefore the empirical basis for

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making an assessment is weak. However, in almost all world regions, there have been attempts at conflict resolution with a more or less significant element of regional intervention, often in combination with multilateralism (UN involvement). Perhaps the preferred future world order can be characterised as regional multilateralism? In contrast with the worst 'clash of civilisations' scenario, this would be a world with largely introverted regions in symmetric balance and involved in a multicultural dialogue and a constructive political relationship.

Development Regionalism

By development regionalism, I refer to measures from a group of countries within a geographical region to increase the efficiency of the total regional economy and to improve the collective position in the world economy. The new regionalism may also provide solutions to development problems. This can in fact also be seen as a form of conflict prevention since, as was noted above, many of the internal conflicts are rooted in development problems of different kinds. Under the old regionalism, free trade arrangements reproduced centre-periphery tensions within the regions which made regional organisations either disintegrate or fall into slumber.

Let me propose seven arguments in favour of a more comprehensive development regionalism:

- *The sufficient size argument.* Although the question of size of national territory might be of lesser importance in a highly interdependent world, regional cooperation is nevertheless imperative particularly in the case of micro-states who either have to cooperate to solve common problems or become clients of the 'core'.

- *The viable economy argument.* 'Self-reliance' was rarely viable on the national level and has now lost its meaning, but a strategy of 'development from within' may yet be a feasible development strategy at the regional level, for instance in the form of coordination of production, improvement of infrastructure, and making use of various economic complementarities and dynamic factors.

- *The credibility argument.* Economic policies may remain more stable and consistent if underpinned and 'locked in' by regional arrangements which cannot be broken by a participant country without provoking sanctions from the others. This argument can be extended to cover political credibility as well.

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- *The effective articulation argument.* Collective bargaining on the regional level could improve the economic position of marginalised countries in the world system, or protect the structural position and market access of emerging export countries.

- *The social stability argument.* Regionalism can reinforce societal viability by including social security issues and an element of social or regional redistribution (by regional funds or specialised banks) in the regionalist project.

- *The resource management argument.* Ecological and political borders rarely coincide, so most serious environmental problems cannot be solved within the framework of the nation-state. Some problems are bilateral, some are global and quite a few are regional. The latter are often related to water: coastal waters, rivers and ground water. Like a regional security complex, we can speak of a regional ecology complex. The fact that regional resource management programmes exist and persist, in spite of nationalist rivalries, shows the imperative need for environmental cooperation or "environmental regionalism".

- *The peace dividend argument.* Regional conflict resolution, if successful and durable, eliminates distorted investment patterns since the 'security fund' (military expenditures) can be tapped for more productive use.

VII Conclusion

In sum, development regionalism contains the traditional arguments for regional cooperation such as territorial size, population size and economies of scale, but more significantly, it also addresses new concerns and uncertainties in the current transformation of the world order and world economy. There is a vicious circle where conflict and underdevelopment feed on each other. But the circle can also become positive. Regional cooperation for development would reduce the level of conflict, and the peace dividend facilitates further development cooperation. Regional peace thus becomes a comparative advantage in an integrating but turbulent world economy. Consequently, regional conflict means disaster for millions of non-combatant populations as the catastrophes in Central Africa and the Horn of Africa show.

The ASEAN component of the Southeast Asian region is a good demonstration of the economic value of regional stability. Another ex-Third World region that is experiencing relative peace today is Latin America

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which may be said to have gained a comparative advantage in peace and political stability. In Central America, formal regional institutions did nothing to facilitate a process of regional integration in the era of old regionalism, but in the last few years, conflict resolution, in combination with more compatible and internationally acceptable economic policies, has moved the small and fragile states closer together and created a new dynamism in the region. South Asia has a good chance of improving its structural position if India and Pakistan can come to terms with each other. Similarly Southern Africa can, through the new political order established in South Africa, begin to strive towards intermediate status.

Security and development form one integrated complex. They constitute two fundamental imperatives for regional cooperation and increasing regionness. Thus, political will and political action will play their part in breaking the vicious circle of uneven globalisation, regional conflict, underdevelopment and human insecurity. This is particularly the case in the peripheral regions of the 'New Third World'.

The Policy Challenges of Regionalisation and Globalisation

Charles P. Oman

I Introduction

My comments will draw mainly from research that we completed at the OECD a couple of years ago on globalisation and regionalisation and their policy implications for developing countries. Let me lay out some of the bases and findings of that research before focusing more explicitly on the debate over multilateralism and regionalism.

First, some working definitions are important to set the frame of the debate. These are rather broad and uncontroversial definitions. I find it most useful to define *globalisation* as the growth, or more precisely the accelerated growth, of economic activity that spans politically determined national and regional boundaries. I would define *regionalisation* as the movement of two or more societies towards greater integration with one another. Regionalisation can of course be driven by the same economic forces that drive globalisation (indeed, that seems to be largely what has been happening in recent years in East Asia, and happened in North America before NAFTA), or it can be driven by political forces which may in turn be motivated by security concerns and/or by economic objectives. Note, however, that even when the objectives of politically-driven regionalisation are primarily economic, they may *not* primarily be *trade* concerns – i.e., despite their name, free trade agreements do not always have as much to do with trade as one may think. In NAFTA, for example, the major motivations on both the US and Mexican sides had less to do with bilateral trade liberalisation or increasing market access *per se* than with locking-in policy reforms in Mexico and, for Mexico, with attracting FDI. Trade policy reform and trade liberalisation, and regional trade or integration agreements in particular, are often important political and policy vehicles used to achieve other ends, both in the realm of security concerns, as in Europe, and broader economic objectives, as for Mexico in NAFTA. As Mancur Olson has pointed out, regionalisation can also constitute a powerful policy tool to weaken the often highly destructive and rigidifying political and economic powers of entrenched oligopolistic special-interest groups, for example.

Regionalisation can also take many juridical forms, including those of a free trade agreement, customs union, common market, single market, monetary union, and even fully fledged economic, monetary and political unification. And of course, the movement can be voluntary or involuntary. The movement that Arvind Panagariya presented earlier, for example, of the English colonisers integrating India, was probably involuntary as far as those 25 regions were concerned, but it is a classic example of movement toward greater regional integration; the processes that led to the creation of nation states in France and England, and more recently in Italy and Germany, are further examples of what I would call processes of regional integration, or regionalisation.

II Three Waves of Globalisation

But let me focus first on *globalisation*. One inference I would draw from my definition of globalisation, is that globalisation is not a new phenomenon. The last 100 hundred years alone have been witness to three distinct periods, or waves, of strong globalisation. The first wave was during the 50 years or so that preceded World War I. Then, as now, world output was growing strongly and trade growth was even stronger than output growth. That rapid growth of trade was facilitated by at least two phenomena. One was significant technological progress in international communications and transportation, and in the way production itself was organised. Another was a significant lowering of policy barriers to trade and investment in some regions. During that period, as now, international and intercontinental *investment* also grew explosively, even faster than trade growth. And then as now, a lot of that explosive growth in international investment was in the form of financial flows. Also, then as now, inequalities of wealth and income within and between countries grew significantly. Perhaps the most obvious *difference* between the wave of globalisation in that period and today is that back then there were huge flows of international and intercontinental migration, with tens of millions of people emigrating from Europe alone; today, the possibilities for such migration are much more limited.

That wave of globalisation culminated in World War I and largely collapsed during the interwar period with the social and economic disasters of the 1920s and 1930s.

The next wave of globalisation was during the 1950s and 1960s. Then, as now, world output growth and productivity growth strongly benefited from major technological advances (many accumulated during the 1930s and 1940s) and from significant reductions in policy barriers to trade, especially in the advanced countries. Then, as now, international investment

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also grew explosively, much faster than trade – with the difference that this time it was not so much financial flows but FDI and the proliferation of multinational corporations, especially US-based manufacturing companies, which were investing in Canada, Europe and Latin America. This second wave of globalisation, like today, was also accompanied by a significant wave of regionalisation (I am thinking especially of the formation of the Common Market in Europe, more than of the largely unsuccessful attempts at regional integration in Latin America and Asia). This new wave of globalisation tapered off in the 1970s as productivity growth rates fell very markedly in all of the leading economies.

What, then, is so special about globalisation today?

I believe one cannot adequately understand globalisation, at least from a policy perspective, simply by looking at patterns of international trade and investment, or by looking at trade and investment policies. To grasp the specificity of globalisation today, relative to earlier periods, one must grasp the nature of change in the microeconomic forces that drive globalisation. I refer to the way in which economic activity is organised, both within firms and between firms who are competing and cooperating with each other.

The gist of my argument is perhaps best explained by using the concept of Taylorism, or what Frederick Taylor himself liked to refer to as 'scientific management'. It was actually during the period of globalisation that preceded World War I that the organisation of mass production developed, as did the modern joint-stock corporation which separated management from ownership. These developments gave rise in the US, on the eve of World War I, to the rise and spread of the principles of scientific management in the organisation of production in a growing number of sectors.

Taylorist organisations can be described as taking many sizes, shapes and colours, but as having three things in common. One is that in the human activity of production, there is a tendency to separate 'thinking' from 'doing' – you have people hired to be the thinkers and people hired to execute: managers and specialised engineers on the one hand, workers on the other.

The second feature of Taylorist organisations is a tendency to push specialisation as far as possible, which in turn leads to very narrowly defined job responsibilities in production. (Many of my fellow economists, at the OECD and elsewhere, seem to think that the efficiency gains to be derived from increased specialisation and economies of scale stem from a universal law of nature, and are not dependent on or specific to any particular paradigm of production, i.e., of the way work is organised. I think that view is mistaken. One has to look at the benefits to be derived from economies of scale and increased specialisation as specific to particular paradigms of organisation. This problem is only amplified, moreover, by the fact that so

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many economists see technology – certainly including the way the work of human beings is organised within firms – as a black box.)

The third feature of Taylorist organisations is a tendency to believe that, at any given time, there is one best way of doing things – hence the term 'scientific'. (All three of these features of Taylorist organisations are nicely illustrated in Charlie Chaplin's movie *Modern Times.)*

Only after World War II did Taylorism spread widely outside the US. It spread to Europe, notably in conjunction with the technical assistance programmes of the Marshall Plan. Carl Dahlman at the World Bank recently produced a study reminding us of the thousands of foremen, middle managers and top managers who went from Europe to the US, and vice versa, under the Marshall Plan to disseminate the principles of 'scientific management' in Europe after the War. That dissemination was also promoted by the major flow of foreign direct investment by US multinationals into Europe at the time. Taylorism also spread to much of the so-called modern sector in many developing countries during the 1950s and 1960s – both in those that were pursuing import-substituting industrialisation and in those few that were pursuing export-oriented manufacturing growth strategies. Taylorism was pursued as well in many of the centrally planned economies, where Stalinist approaches to production were a veritable caricature of Taylorism and scientific management.

It was that spread and the ongoing development at the time of Taylorist approaches to the organisation of economic activity which, in my view, drove globalisation during the 1950s and 1960s. Taylorism contributed to the very strong growth of productivity levels in those years, worldwide. And, it is worth noting, Taylorist principles were also very influential in guiding the development of many public organisations, both domestic and international, during the postwar period.

The three features of Taylorism that so well served productivity growth during the 1950s and 1960s also led, however, to an accumulation of serious bureaucratic rigidities in the very fabric of the organisation of economic activity. Those rigidities were, in turn, a major cause of the marked slowing of productivity growth in the 1970s, notably in the leading economies, where 'scientific management' was most developed, widespread and entrenched. That slowing of productivity growth was, in turn, a major cause of the emergence of *stagflation*, i.e. slow growth, high unemployment and high inflation. Stagflation plagued both the US and Europe in the latter half of the 1970s and, we might note in passing, devastated Keynesian economic thinking.

III Post-Taylorism

Market deregulation – to stimulate competition – and monetary shock treatment – to cut inflation – were the twin policy responses to stagflation in the OECD countries, starting in the late 1970s. Deregulation was actually launched in the United States under the Carter administration in the late 1970s. It was followed by the Thatcher government, which pursued privatisation along with deregulation, after Mrs. Thatcher's election in 1979. It was pursued by the Reagan administration in the US after 1980. And Anglo-Saxon deregulation put tremendous pressure on continental Europe to follow suit, which – to make an interesting story very short – led to the launching of the Single Market programme by the EC in 1985.

I am arguing, in other words, that the Single Market programme was continental Europe's deregulatory policy response to Anglo-Saxon deregulation as well as to Eurosclerosis (as stagflation was called then in Europe) and to perceptions in Europe that the centre of economic gravity was shifting from the North Atlantic to the Pacific. The Single Market programme was a policy-led deepening of European regional economic integration designed to stimulate competition within Europe in order to strengthen European competitiveness in global markets and stimulate growth at home.

The US, to complement its deregulatory moves at home and its monetary shock treatment to cut inflation, proposed at the GATT Ministerial in 1982 to launch a new round of multilateral trade negotiations. But the US was turned down by the European Commission and the European Community, who did not want to launch a new round of multilateral trade negotiations until they got their regional house in order, i.e. until they were able to launch their process of deregulation at home, in the form of the Single Market programme. Only after the launching of the Single Market programme in 1985 did the EC support, in 1986, the launching of the Uruguay Round.

One result of this delay was that the US then proceeded to change its own position on regionalisation, from having systematically resisted and refused to engage in *de jure* regionalisation at home – though there was substantial *de facto* regionalisation between the US and both Mexico and Canada – to pursuing it actively. The US proceeded to negotiate the Canada-US Free Trade Agreement, signed in 1988, and then to launch bilateral negotiations with Mexico which ultimately led to the signing of NAFTA in 1992.

One can thus argue that the stagnation of productivity growth and the slowing of globalisation that came with it in the 1970s gave rise to a new round of regionalisation, starting in Europe and followed in North

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America – with a lot of knock-on effects in terms of the impulse given to regional agreements elsewhere (the ASEAN FTA, Mercosur, etc.).

In the meantime, the policy responses to stagflation – notably the monetary shock treatment by the US Fed to cut inflation – led to deep recession in the early 1980s. At the same time, US companies began to lose significant market shares to Japanese auto and electronics imports in the US market because the late 1970s and the early 1980s also witnessed the coming of age of a number of, what I would call, post-Taylorist flexible organisations in Asia – organisations which proved highly competitive in world markets.

Post-Taylorist organisations, like Taylorist organisations, can be described as taking many sizes, shapes and colours. They include both the large-firm variety, such as Toyota, Mitsubishi or Hewlett Packard for example, and the small-firm variety in the form of certain industrial clusters. Post-Taylorist organisations include firms in modern services as well as in manufacturing – i.e., their relevance, and that of the analysis I am putting forward, is certainly not limited to the manufacturing sector. And they all have three common features, which are exactly the reverse of those characterising Taylorist organisations: (i) They have a tendency to re-integrate thinking and doing in production – if only to better exploit the human intelligence of their workers and their capacity to perceive and find creative solutions to new problems. (ii) They emphasise teamwork and more broadly defined job responsibilities – an emphasis which in turn holds major policy implications in the fields of education, multi-skilling, and many other areas in the realm of human resources development, infrastructure, and others that are simply too numerous to develop here. (iii) They have a tendency to emphasise the importance of continuous innovation in the *way* things are produced, as well as in *what* is produced.

The key point is that the most productive post-Taylorist organisations can attain levels of labour productivity and capital productivity far superior to those that the most productive Taylorist organisations can attain. It is the ongoing spread and development of post-Taylorist approaches to the organisation of activity, especially in the leading economies, that is the driving force of globalisation today.

But Taylorist organisations continue to account for a large share of output and employment in the OECD countries, where the mentality of 'scientific management' is still widespread and deeply entrenched in the overall fabric of production and the organisation of economic activity – and in the fabric of policy thinking, and the organisation of public institutions as well. Resistance to moving from traditional Taylorist ways of thinking and organising to post-Taylorist flexible ways of thinking and organising is thus strong. That resistance constitutes the major 'structural' cause of the job-market problems (and 'globaphobia') that have come to plague the OECD countries – notably high unemployment in Europe and rising inequality and job insecurity among workers in the US – over the last ten to fifteen years.

While this resistance is partly caused by a lack of flexibility in labour markets in Europe, moreover, there is a lot of resistance to change that starts at the level of top management, with people who have often built brilliant careers thanks to their ability to see the world through Taylorist glasses, and who find it hard to perceive problems, much less solutions, through other than Taylorist glasses. There is also a lot of resistance to change by middle management whose jobs would either disappear, or be changed beyond recognition, in a post-Taylorist organisation. There is a lot of resistance to change by skilled labourers whose skills, perhaps accumulated over a lifetime of work experience, are often too narrowly defined for the needs of post-Taylorist organisations. And, of course, unskilled labour is the biggest loser of all because they have little place in post-Taylorist organisations.

IV Globalisation and Regionalisation

What does all of this have to do with the debate about regionalism and multilateralism? Given the time, I would like to highlight one main point: the importance of understanding that the same microeconomic forces which are driving globalisation in the real economy today are also an important force working for regionalisation, including *de jure* forms of regionalisation. This was particularly visible in the years 1990 to 1993, for example, when the Uruguay Round was in difficulty. Although multinational corporations certainly favoured bringing the Uruguay Round to a successful conclusion, what many people found surprising at the time was that they were *not*, on the whole, the strong driving political force for a successful conclusion of the Round that many expected them to be. We asked Lou Wells to do a paper on that subject and he came up with a very interesting finding. He called it the 'Big Yawn' thesis. His thesis – and I find it persuasive in view of the evidence (with the data we have today I find it even more convincing) – is that many multinational corporations were – and remain – much more interested in pursuing the lowering of barriers to economic activity *within* each of the three major regions of the global economy, than they have been concerned about any danger of a collapse of the Uruguay Round and the possible rise of inter-regional barriers to trade that could be the consequence of such a collapse. They would have been worried about any increase in inter-regional barriers to *investment*, of

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course, but few MNCs saw that as a serious likelihood even in the worst-case scenario of a collapse of the Uruguay Round.

Likewise, to take a more recent example, many US firms feel deeply stunned by the apparent collapse of possibilities for the US Congress to give the President 'fast track' authority for the negotiation of new international trade accords. But most of those firms' deepest concern stems, again, from what that collapse means for *regional* integration in the Western Hemisphere, more than from what it might mean in terms of negotiating post-Uruguay Round issues at the multilateral level (i.e. for WTO negotiations).

Part of the reason for this multi-*regional* focus by many MNCs – and not only US multinationals – is that while a lot of their physical production and sourcing of inputs is becoming more international, that internationalisation of sourcing is occurring mainly *within* regions as opposed to *between* regions. In other words, while it makes a lot of sense to talk about the globalisation of markets, about the globalisation of competition, and about the globalisation of many corporate functions, including management systems and so on, it really is a misnomer to talk about the globalisation of physical production, i.e. of the sourcing of physical inputs *per se*. It is more accurate to talk about the *regionalisation* of production.

Another part of the reason why multinational corporations are in favour of regionalisation is that firms are pushing for what Robert Lawrence and others have called 'deep' policy integration, i.e. going beyond border measures to reduce international discrepancies in policy matters normally considered domestic. While WTO negotiations focus heavily on these measures already, regional agreements are seen by many MNCs as a necessary complement or, more often, a necessary precursor to serious progress on these issues in the WTO.

I should reiterate, by way of conclusion, that the potential value of *de jure* regionalisation is also a potentially powerful means to weaken entrenched, rigidifying oligopolistic interest groups in countries within the region, and in doing so to stimulate the forces of domestic competition and enhance their economies' flexibility. This stimulus to competition may induce economic benefits that are significantly greater than any efficiency gains which can be derived from greater specialisation *per se*. In other words, I am highlighting the dynamic as opposed to the static gains of regionalisation.

Of course, this takes us back to the logic of Europe's Single Market programme, and more generally to the point that in practice, and historically, globalisation and regionalisation tend naturally to be mutually reinforcing – but only insofar as regionalisation stimulates competition within the region. When *de jure* regionalisation becomes a tool for regional protec-

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tion, which is a permanent danger, it loses its value as a policy tool for strengthening the region's growth and competitiveness in global markets and becomes counterproductive.

Floor Discussion of "Regionalism and Multilateralism: The Debate Reviewed"

Capital, Labour and Standards of Living

Charles Oman's historical comparison of waves of integration generated a number of interesting comments and questions from the participants. For instance, Salvatore Zecchini emphasised the importance of technological advances in the development of new approaches to enterprise management and wondered why Oman had not mentioned this explicitly in his presentation. "Is it so self-evident that it does not deserve mention? I think, however, that it certainly requires some reflection because disruptions in this process of technical advancement may result in discontinuity in the ongoing process of globalisation."

Oman agreed and elaborated on Zecchini's point. "The apparent implication of new technology is that it strengthens decisionmaking power in the centre of a firm so that many subsidiaries become less autonomous and less capable of taking initiative than in the past. Thus, your observation about technology advances points to an argument regarding the loss of sovereignty of subsidiarities, but this is only one dimension. Equally important is the labour/capital dimension and whether labour is going to become more empowered or less empowered. I tried to take a more or less neutral stance by pointing out that it is not necessarily a better nor a worse world for workers. The issue is not so much one of economic efficiency as it is one of political power. Your point is extremely important because in today's world, the efficiency with which these new technologies are actually used by companies depends much more on the way human beings in the company are organised than on the amount of money they invest in new technologies."

András Inotai followed up commenting that capital, trade and most services are global but labour is not. "The issue of globally moving capital and regionally moving labour is a particularly important issue if we want to forecast the future of global capital flows and high-level unemployment, for example in Europe. In terms of accession to the EU, it does not matter what measures the EU takes with regard to the labour market because capital cannot be restricted. The more the market is restricted, the more capital may flow out of Western Europe. How do you look at this issue and are there any parallels regarding other regional groupings?"

Stephany Griffith-Jones compared the differences in movement of

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labour in the 19th and 20th century. "In the 19th century, there was substantial freedom of labour movement from the developed countries to the developing countries of the time such as the resource rich United States, Argentina and Australia. This complemented the rapid movement of capital which was going the same way. The current situation is quite different because while capital is still going from the developed countries to the developing countries, there are more restrictions on labour movement than before. Now the movement is basically from the less developed to the more developed countries – NAFTA is not about allowing Mexicans to live and work in the US. Thus, globalisation is more asymmetric than in the 19th century."

Charles Oman responded by first distinguishing between foreign direct investment (FDI) and portfolio investment. "FDI is not as mobile as portfolio capital and therefore not as much of a problem as some suggest. I try to analyse the mobility of financial capital in the context of the significance of financial activity *per se*, and there is some interesting data in Europe and North America which clearly show a shift of tax incidence away from capital and onto labour. For example, there is a tendency to increase consumption taxes, which are regressive, and reduce enterprise taxes. This is the dual problem of the weakening of the fiscal base of governments and the shifting of the tax base from the mobile factor to the immobile factor. All of this feeds back into the issue of the sharing of the benefits or the potential benefits of productivity growth associated with globalisation and increased competition. Obviously, the mobility of financial capital has seriously weakened national economic policies and the autonomy of nation states, but we should not exaggerate this either."

Ricardo Ffrench-Davis suggested that, theoretically, increases in productivity should result in an improvement in standards of living. However, according to Ffrench-Davis, reality is different. "When we measure growth and income equality, we tend to find that productivity growth is accompanied by greater income disparity. How can we improve this? We need to remember that the goal is not globalisation, but the improvement of standards of living. Globalisation and regionalisation should be means to achieve this larger objective."

Charles Oman agreed with the thrust of Ffrench-Davis's comment, but questioned the economic mechanisms at work in such a dynamic. "I would like to think that productivity growth will increase standards of living for everybody, and Paul Krugman and many others always point out that, historically, wage rates and living rates normally accompany productivity levels. But what are the mechanisms that bring this about? My own view is that equilibria do not just work themselves out by magic. On what basis should we assume that productivity levels will result in an increase of the

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standards of living of everybody? Is this a normative statement or an analytical observation? There is nothing automatic in either the economic or the political mechanisms at work to lead to such increases."

Regionalisation versus Multilateralism

A discussion of regionalisation and globalisation included defining the terms and the sequencing of both processes. Using examples from their own regions, the participants debated the notion of regionalism as a stepping stone or a stumbling block to multilateralism. Mohamed El-Erian said that while there are valid theoretical arguments for both sides of the argument, practical experience gives the final proof. As an example, he referred to a recent seminar in Washington on the scope for a US-Egypt trade arrangement. "The Egyptian view was that such an arrangement would divert them from the multilateral trade route. In addition, they would have to devote a lot of their capital to confront vested interests, and this would use up all of their good will. So in this case, a free trade arrangement would not be a stepping stone."

Arvind Panagariya mentioned that in the US, aspects of regionalism have been quite damaging to multilateralism. "The NAFTA debate polarised the interest groups. It is difficult to call it free trade because while multilateral rounds went through Congress with relative ease, the NAFTA debate was very contentious. And in the end, the parties had to pretend that those labour and environment conditions had to be brought in to actually carry NAFTA through Congress, which was a bit disconcerting. Also, some of the issues that were raised in the discussions about NAFTA, such as labour standards, turned into effective global demands. This raised the idea that if it could be done in a regional way it could be done globally as well, and we saw the emergence of the labour standards issue coming into the multilateral fora, which was finally contained of course."

Robert Devlin highlighted the importance of distinguishing between the initial concept of a trade agreement and the end result which might be the outcome of bad negotiations. "In the case of NAFTA, there are aspects which can be criticised quite strongly. The rules of origin in NAFTA set a bad precedent, because they are terribly complicated and restrictive in a number of sectors. But the rules of origin are the outcome of negotiations. There were a lot of issues at play in the NAFTA negotiations, and while NAFTA itself is not necessarily bad, there are bad aspects of the NAFTA negotiations. Another result of NAFTA negotiations is the longer phase-out period for the companies which were able to lobby the most. While this may guarantee sustainability to the agreement, it reflects a certain inequality on the power of the various parties to the negotiations."

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Björn Hettne stressed the importance of realising that a regional framework can be used for different purposes. "It does not imply anything except that institutional means exist to pursue certain policies. The kind of policies you pursue, however, depend on the interest of the actors. In my world map, which consists of core, intermediate, and periphery regions, the core regions of East Asia, North America and Europe pursue rather liberal trade policies because the basic point of strong economies is to gain access to weaker economies – as has always been the case in free trade agreements. At the intermediate level, there is an ambivalent view of regionalism; it can either be something favouring international free trade, or it can be a movement toward a less open and more introverted type of regionalism. This is illustrated clearly in the ECLAC documents on new regionalism where it is viewed, among other things, as a kind of precautionary measure against the European fortress or the NAFTA fortress. In the case of the periphery, there is a strong intervention argument for a group of countries interested in joint infrastructural projects, free trade agreements, etc. In my paper, I have included seven arguments in favour of regionalism as a means to promote development. I think that if an FTA or a PTA is needed to promote cooperation in controlling river systems, environmental protection or even peacekeeping, it is a cost worth paying."

Robert Devlin mentioned the case of infrastructure in South America. "We are all concerned about cost-benefit analysis, but six years ago, no amount of cost-benefit analysis alone on the Southern Cone waterway would have led to its implementation because the countries did not want infrastructure connections. These regional arrangements can be a way of encouraging countries to actually do the cost-benefit analysis and when it is positive, to make the investment."

Arvind Panagariya, however, continued to emphasise the importance of cost-benefit analysis for infrastructure investments. "Just because a bridge exists that would not have existed if not for Mercosur, does not imply that it was a good thing. The question is what did we forego in return. And to the extent that the regional arrangement may distort prices, which in turn distorts our evaluation of the project itself, there is a problem. Maybe you are first diverting trade and then you are diverting infrastructure investment."

Percy Mistry observed that a region like Africa will benefit from a regional approach simply because most African markets are too small and fragmented to function properly. "Unless those markets are enlarged in some reasonable way and are given a chance, there is simply no way for them to escape from the trap in which they find themselves. This is an intuitive and instinctive type of argument, but I arrive at it through a rejection of the alternatives. And Africa is not the only special case, SAARC might be included here as well."

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Definition of Terms

The participants finally turned to the issue of definitions and their implications. Robert Devlin stated that open regionalism was generally viewed as a tool for promoting liberalisation and competition. "These agreements in Latin America make sense only to the extent that they raise competition, erode monopoly rents and permit the countries to move forward in opening up their economies and making them competitive. This is the spirit of open regionalism, and any agreement which does not result in increased competition or lowered external tariffs over time would not be included in this definition."

Percy Mistry considered the broad views presented by Björn Hettne and Charles Oman a useful reminder that there is a world beyond economics. "The whole debate on regionalism has been driven by trade theorists ever since Jacob Viner, but now there are a lot more people and disciplines that want to have their say in defining, shaping and moulding this phenomenon. The views presented by Arvind Panagariya, rigourous as they are, are neither less relevant nor less important, but need to be placed in a wider context. There is no satisfactory theory to regional integration the way it used to exist between the 1950s and the 1970s, and we are sort of playing around with a messy range of intellectual concepts trying to bring things together. Much more work needs to be done on what we used to call externalities simply because we couldn't quantify them or couldn't explain them.

The second thing that strikes me is that even on the economic frontiers of regionalism and regionalisation, there is a very large part of it – as recent financial turmoil in Asia has demonstrated – which we traditionally veered away from but which should become an integral part of regional integration theory and practice, and that is monetary arrangements, especially the issue of withstanding financial shocks. Given the fact that the contagion effects, and indeed in some regions the concentration effects, of portfolio investments are largely intra-regional, we should seriously examine the question of whether the region should intervene. The European Union has come to the conclusion that monetary issues are important and the Asians, who have not been convinced of the economic benefits of regionalism, have also concluded that this area of finance deserves some attention. It strikes me as odd that even in this area of macrofinance, where we can do some quantification and rigourous analysis, we have not really focused on the regional dimensions of monetary policy."

Björn Hettne stressed that the nature of the process of regionalisation depends on the ideology that is adopted. "It can be a neo-mercantilist project or an open regionalism project – it could even be neo-liberal project.

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Regionalisation is a process which can be spontaneous or deliberate, and it can occur along various dimensions as well. The outcome may lead to a new regional actor with the capacity to act. This was the basic idea behind the Maastricht proposal to make the European Union an actor in its own terms, but it may have had its funeral in Amsterdam.

It is also interesting to contemplate what is new about globalisation, and the fact that we use a new concept implies some newness about it. I prefer to use the term globalisation to refer to the last two decades of internationalisation implying that there is some kind of qualitative change here – it is more than the internationalisation of economies. The information technology is one important aspect of this fundamental difference. Perhaps this discussion about capital and labour movement should also be included in the definitions of globalisation and regionalisation since regional arrangements are partly intended to control the movement of people. This control can be done in ways which are not so nice, as we see in Europe. As for the sequencing of globalisation and regionalisation, I think that currently, globalisation occurs alongside regionalisation whereas, if you go back a couple of decades, the internationalisation of economies occurred in the bilateral system. The notion that globalisation is accompanied by regionalisation is one of the new things about the current wave of globalisation."

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Appendix

List of Participants in the Conference on "Regional Economic Integration and Global Economic Cooperation: The Challenges for Industrial, Transitional and Developing Countries", held at the Dutch Ministry of Foreign Affairs on 18-19 November 1997

Mr. Ernest Aryeetey	Senior Research Fellow, Institute of Statistical, Social and Economic Research, University of Ghana
Ms. Rosanne Beckers	Economist, Foreign Financial Relations Directorate, Ministry of Finance, the Netherlands
Mr. Hein Bogaard	Junior Advisor, Multilateral Banks Division, Ministry of Finance, the Netherlands
Mr. Lucas ter Braak	Economist, Monetary and Economic Policy Department, De Nederlandsche Bank, Amsterdam
Ms. Anna Brandt	Deputy Director, Division for Central and Eastern Europe, Ministry for Foreign Affairs, Sweden
Mr. Andrew Cornford	Senior Economic Advisor, Division on Globalisation and Development Strategies, UNCTAD, Geneva
Mr. Ed Craanen	Director, Western Hemisphere Department, Ministry of Foreign Affairs, the Netherlands
Mr. Ron van Dartel	Director, European Affairs Department, Ministry of Foreign Affairs, the Netherlands

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Mr. Robert Devlin	Chief, Integration, Trade and Hemispheric Issues Division, Inter-American Development Bank, Washington, D.C.
Mr. Jean-Paul Dirkse	Director, Cultural Cooperation, Education and Research Department, Ministry of Foreign Affairs, the Netherlands
Mr. Zdeněk Drábek	Senior Adviser, Economic Research and Analysis, World Trade Organization, Geneva
Mr. Dag Ehrenpreis	Chief Economist, Policy Department, Swedish International Development Cooperation Agency (SIDA), Stockholm
Mr. Mohamed A. El-Erian	Deputy Director, Middle Eastern Department, International Monetary Fund, Washington, D.C.
Mr. Ricardo Ffrench-Davis	Principal Regional Advisor, UN-Economic Commission for Latin America and the Caribbean (ECLAC), Santiago de Chile
Ms. Teresa Fogelberg	Head, Research and Developing Countries Division, Ministry of Foreign Affairs, the Netherlands
Mr. János Gács	Acting Project Leader, Economic Transition and Integration Project, International Institute for Applied Systems Analysis, Laxenburg, Austria
Mr. Branislav Gosovic	Director, The South Centre, Geneva
Ms. Stephany Griffith-Jones	Senior Fellow, Institute of Development Studies, Sussex University, UK
Mr. Jan Willem Gunning	Professor of Economics, Free University of Amsterdam

Mr. Göran Hedebro	Head of SAREC's Division for Thematic Programmes, Swedish International Development Cooperation Agency (SIDA), Stockholm
Mr. Barry Herman	Chief International Economic Relations Branch/MD, Department of Economic and Social Information and Policy Analysis, United Nations Headquarters, New York
Mr. Ingmar van Herpt	Economist, Foreign Financial Relations Directorate, Ministry of Finance, the Netherlands
Mr. Björn Hettne	Professor in Peace and Development Research, Göteborg University, Sweden
Mr. Winfried Houtman	Head, European Union Division, Ministry of Finance, the Netherlands
Ms. Marie Hulsman-Vejsová	Senior Officer, Research and Developing Countries Division, Ministry of Foreign Affairs, the Netherlands
Mr. András Inotai	General Director, Institute for World Economics of the Hungarian Academy of Sciences, Budapest
Mr. Jan Willem van der Kaaij	Head, Multilateral Banks Division, Ministry of Finance, the Netherlands
Mr. Mats Karlsson	Under-Secretary of State, Ministry for Foreign Affairs, Sweden
Mr. Fred van der Kraay	Inspector, Policy and Operations Evaluation Department, Ministry of Foreign Affairs, the Netherlands
Mr. Maarten Lak	Deputy Director, European Affairs Department, Ministry of Foreign Affairs, the Netherlands

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Mr. Hans Peter Lankes	Senior Economist, European Bank for Reconstruction and Development (EBRD), London
Mr. Frans van Loon	Director Emerging Markets Group, ING Bank International, Amsterdam
Mr. Jens Lund-Sörensen	Managing Director, Nordic Development Fund, Helsinki
Mr. James Lynch	Political Counsellor, Canadian Embassy in the Netherlands
Mr. Gavin Maasdorp	Director, Economic Research Unit, University of Natal, South Africa
Mr. Mark Malloch Brown	Vice-President for External Affairs, The World Bank, Washington, D.C.
Mr. Percy S. Mistry	Chairman, Oxford International Group, Oxford, UK
Mr. Carlos Neves Ferreira	President, Institute for Economic Cooperation, Ministry of Foreign Affairs, Portugal
Mr. Bertil Oden	Coordinator, Southern Africa Programme, The Scandinavian Institute of African Studies, Uppsala, Sweden
Mr. Frits W. Olivier	Deputy Head, Southern African Division, Ministry of Foreign Affairs, the Netherlands
Mr. Charles P. Oman	Head of Research Programmes, OECD Development Centre, Paris
Mr. Arvind Panagariya	Professor of Economics, Co-director, Center for International Economics, University of Maryland, College Park, US
Ms. Miria Pigato	Senior Economist, The World Bank, Washington, D.C.

Mr. Henk Post	Head of Cabinet of Commissioner van den Broek, European Commission, Brussels
Mr. Nick van Praag	Director, External Affairs, European Office, The World Bank, Paris
Mr. Jan P. Pronk	Minister for Development Cooperation, the Netherlands
Mr. Peter Robinson	Zimconsult, Independent Economic & Planning Consultants, Harare, Zimbabwe
Ms. Annemarie Sipkes	Economist, Monetary and Economic Policy Department, De Nederlandsche Bank, Amsterdam
Ms. Piritta Sorsa	Deputy Chief, Trade Policy Division, Policy Development and Review Department, International Monetary Fund, Washington, D.C.
Mr. Jan Joost Teunissen	Director, Forum on Debt and Development, The Hague, the Netherlands
Mr. André E. Thibeault	Director, Centre for Finance, Nijenrode University, Breukelen, the Netherlands
Ms. Rosalind Thomas	Principal Policy Analyst, Development Bank of Southern Africa, Midrand, South Africa
Ms. Seija Toro	First Secretary, African and Inter-American Development Banks, Department for International Development Cooperation, Ministry of Foreign Affairs, Finland
Mr. Erik Visser	Economic Counsellor, South African Mission to the European Union, Brussels
Mr. Robert Vornis	Director, Multilateral Development Financing and Macro-Economic Affairs Department, Ministry of Foreign Affairs, the Netherlands

Mr. Samuel Wangwe	Executive Director, Economic and Social Research Foundation (ESRF), Dar-es-Salaam, Tanzania
Mr. H. Johannes Witteveen	Economic Adviser, former Managing Director of the International Monetary Fund, the Netherlands
Mr. Salvatore Zecchini	General Director, Ministry of Budget and Economic Planning, Italy