3 Reducing Non-Tariff Barriers

The potential orthodox and unorthodox gains to be derived from RIAs are unlikely to be realised if tariff barriers are reduced, but non-tariff barriers to integration remain. Non-tariff barriers that segment regional markets in the developing world can be distinguished as those that affect (i) trade; (ii) production; and (iii) investment. These are taken up below in turn.

Barriers to Trade Gains

Non-tariff barriers affecting trade include quantitative restrictions or voluntary restraints that reinforce tariff protection, and payments barriers that may not be protective in intent but may nevertheless end up having that effect. One feature of these restrictions, particularly of payments restrictions, is that they are apt to work in practice to discriminate against intra-regional trade which is often perceived to involve less essential products.

In the past, non-tariff barriers have been used to protect a particular country's market from competition not only from the rest of the world, but also from other members of an RIA. Such measures are rarely transparent. Their significance cannot easily be determined without laborious research into their quantitative effects. In most of the developing world where the currencies are usually non-convertible, monetary and payments barriers are two of the most significant barriers to trade.

Currency Convertibility and Monetary Harmonisation

The acute shortage of foreign exchange throughout some regions – especially in Africa and, to a decreasing extent, in South Asia and the former CMEA countries – limits the ability of countries to trade with one another. This shortage is, of course, exacerbated by inconvertibility not only into hard currencies but also into regional currencies. Clearing house arrangements have attempted to overcome this barrier but the settlement of net outstanding balances between countries in hard currencies remains a limiting factor.

The extent to which inconvertibility of currencies and state-controlled exchange rates limit intra-regional trade is partly measurable through the amount of unrecorded trade that occurs at unofficial, parallel market rates. Such trade has been estimated by various studies to be in the range of 15-70% of officially recorded cross-border trade in different regions of the world.

Even when currencies are convertible, as in the European Union, they impose significant barriers through the high transactions costs involved in

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exchange. Such costs include those of buying and selling foreign currencies, and uncertainties about future movements in intra-bloc parities which may require forward cover to be bought by firms (at extra expense) in order to protect the value of their revenues. Short of monetary union with a common currency, these costs cannot be entirely eliminated, although clearing and payments unions can help to reduce them. With inconvertible currencies, exchange controls typically constitute a decisive, binding barrier to market unity, outweighing fiscal and tariff barriers in their significance.

Within some common monetary areas in the developing world, and in regions where currency convertibility has been largely achieved, there is both current account convertibility and a fairly liberal capital transfer regime. But in several developing regions there are still severe monetary obstacles to intra-regional trade and investment which arise from overvalued exchange rates and other policy responses to macro-disequilibrium. Their elimination is a prerequisite for effective measures toward further markets integration requiring harmonisation of both current and capital account regimes. Some progress has been made throughout the developing world in the 1980s and 1990s towards bringing official exchange rates closer to market-clearing levels. One approach has been via the operation of dual systems (second windows) under which the exchange rate is fully or partially determined by the market for certain types of transactions.

Studies have been done in developing regions of monetary harmonisation programmes that would be needed if exchange restrictions were to be removed, exchange rates stabilised and inflation rates brought into line. These outline the scale and sequence of required further economic adjustments, and usually lead to proposing monetary unions with a common currency. Such strategy seems to be supported by the experience of the European Union. In the case of NAFTA, however, the problem is partially resolved with all members' currencies being linked to the US dollar in way or another.

The harmonisation element of the programmes proposed is usually seen as a prerequisite to further integration, even though monetary union is something which most members of RIAs are not yet ready to accept. Even the European Union, which is the farthest advanced along these lines, faces serious problems in moving towards it. More precisely targeted proposals for attaining full convertibility therefore need to be worked out in most developing regions, focusing first on countries which are most advanced along the adjustment path.

The removal of monetary obstacles to trade is of course a necessary but insufficient condition for integration. Once major policy disequilibria in the countries concerned have been corrected, mechanisms have to be put in place to encourage the continued pursuit of policies which assure currency stability

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and the maintenance of convertibility and, in so doing, to facilitate the progressive strengthening and deepening of RIAs.

Exchange Rate Regime

This poses the important issue of the appropriate exchange rate regime to be resolved between fixed or more flexible arrangements. Under the *real targets* approach, the exchange rate is an indispensable policy instrument for facilitating adjustment and growth, particularly with inherent volatility in the terms of trade that confront many developing countries. The *nominal anchor* approach rejects the efficacy of nominal exchange rate adjustments, in part because the monetary regime shapes private sector wage and price policies.

Exchange rate flexibility and floating rate arrangements are favoured by the donor community and the international financial institutions (IFIs) for *developing* countries. In contrast the opposite view is taken by the IFIs and governments for *developed* countries where semi-fixity is preferred to reduce undue volatility in currency markets.[16] Such volatility is seen as vitiating the attempts of governments to pursue sensible fiscal and monetary policies which the financial market may (for unrelated reasons) disagree with for longer than is desirable. The arguments against stable exchange rates in developing countries, however, are not convincing in the face of weak systems of domestic restraint and the inability of developing country governments to engineer significant changes in real wages. The adoption of a regime of stable rates, underpinned by credible and robust regional exchange rate stabilisation mechanisms, would certainly also encourage cross-border investment. Evidence now suggests that the tendency to push floating rates in developing countries may have been overdone, perhaps to the detriment of attracting much needed flows of foreign and domestic investment which would enable the desired adjustments in supply-side response to take place.

After major exchange rate misalignments in the member countries of a region have been rectified, one option is for members to harmonise monetary policies by fixing common inflation ceilings and bands. In developing countries, however, such policies are difficult to implement because of tenuous links between targets and instruments. The use of anchor currencies, or of baskets of currencies, to which countries can peg their own currencies

16 Excess volatility is sometimes generated simply because foreign exchange traders want to trade currencies and banks want to derive profits from such trading. Somewhat disconcertingly, a vested interest now seems to have developed within the international financial community to keep exchange rates far more volatile and unpredictable than they need to be or than economic fundamentals suggest they should be.

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would be a better strategy. Pegging to the same external anchor under RIAs can be a useful first step towards monetary harmonisation and stabilisation.

The optimal peg for any particular region would, of course, have to be determined by the patterns of trade and capital flows. The options essentially are the US dollar, the ECU, the SDR, a trade-weighted basket or, for the Asian region, perhaps even the Japanese Yen, just as for West and Central Africa, on a limited basis, it might still be the French franc. Adoption of a common anchor currency would be akin to an informal exchange-rate union, in which the right to change parities would initially be retained.

Monetary initiatives in developing countries usually argue for actions leading to the introduction of a common currency and monetary unions of the type that already exist (e.g. the CFA and rand unions). These are not full monetary unions, since the currency issues in each country are separately identified and national balances of payments are calculated, which ultimately govern national credit and fiscal policies. Contrary to IFI belief, these types of monetary union do not lead to the effective integration of national money markets and do not necessarily constitute a barrier to the operation of country-specific adjustment programmes.

It should be emphasised that monetary arrangements appropriate for developing regions do not depend on prior achievement of a high degree of integration among participating countries. They could just as well precede it. Nor do such unions require prior fiscal integration, though participants should accept firm constraints on resort to public deficit financing. Such arrangements can operate primarily as mechanisms for strengthening adherence to the conditions necessary for maintaining convertibility and fixed exchange rates, while still permitting the retention of national monetary identities and, to a limited extent, the operation of independent national credit policies.[17]

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17 For example, in West and Central Africa, the retention of monetary unions for more than 35 years following independence has depended on the availability of an external guarantor (France), the immediate *quid pro quo* being the acceptance by the countries concerned of constraints on their fiscal and credit policies directly imposed by the guarantor. If some such arrangement for an informal exchange-rate union were to be adopted as a long-term objective in other developing regions, a precondition of its credibility, at least for an initial period, would be support from an equally credible external guarantor (which could be a regional bank or another multilateral agency). The benefits of such an arrangement, and its effect on inward investment, would then be greatly enhanced. Guarantees are evidently unlikely to be forthcoming without the acceptance of significant constraints on the fiscal and monetary policy sovereignty of member states, which they may be reluctant to envisage. But past experience shows that exercising such sovereignty has been a recipe for inflation as many developing governments now acknowledge. Under structural adjustment programmes effective monetary sovereignty has, in any event, been circumscribed by the acceptance of externally imposed monetary targets as a precondition for access to financing.

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Clearing House and Payments Union

A related matter to consider in connection with RIAs in developing countries concerns the role of *clearing houses* in overcoming payment obstacles, especially in regions where normal trade finance linkages and instruments are absent. It may well be that before convertibility is fully attained, there is a good case for adapting this halfway-house in developing regions. An alternative approach would be the establishment of a payments union, resembling the European Payments Union of 1950-58, involving the provision of credit for which external funding has already been sought.

To some extent, a clearing house reduces the need for foreign exchange dealing in convertible currencies for intra-union transactions. However, the extent to which real gains are actually generated will depend on the extent to which savings in the use of foreign currencies are offset by the administrative costs of operating the clearing house itself. In many cases clearing houses under RIAs have not brought any increases in intra-regional trade flows (e.g. in the Preferential Trade Area for Eastern and Southern Africa).

Supporting credit facilities might encourage greater intra-regional trade, but in most developing regions the absence of donor interest in providing financial support makes such facilities difficult to finance. Sadly, such support might be developmentally much more effective than the balance of payments support or the debt service support which donors have traditionally been more willing to provide.

Parallel market rates might also be used in some cases for settling payments for intra-group trade; but although this might expand clearing house activity by restoring some unofficial trade to official channels, it would not necessarily expand intra-regional trade.

If a payments union is to be established under RIAs in developing regions, the case for it must be based on the contribution it makes to liberalising trade and payments – or to preventing trade from contracting in the face of balance of payments pressures – during the transitional period before full convertibility is achieved. In this context, credit facilities would have an important role to play. Still, where intra-regional trade is relatively low, the role of a payments union is likely to remain modest. To the extent that some countries might be persistent creditors in such unions, particular difficulties would arise unless special arrangements were made to reflect their circumstances.

Clearing house and payments union arrangements may *not* be crucial elements in RIAs for particular developing regions. If prematurely considered they may even deflect attention from the real issues. The fundamental question is whether the encouragement of regional trade by the use of parallel rates, and discriminatory relaxation of exchange-related non-tariff barriers, are desirable.

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Whether there is a role for a clearing house should be determined by the relative efficiency of the commercial banking alternatives available in the region. If direct access were allowed to commercial banks, and letters of credit were more widely used in trade finance transactions, the market itself might resolve the issue. A clearing house might be partly justified in terms of its convenience for performing other useful monetary cooperation functions, including monitoring, not already undertaken by other institutions, that might contribute towards more rapid convertibility.

Barriers to Production

Non-tariff barriers affecting production consist of those that affect output by limiting entry to a market or by restricting competition. Such barriers also affect trade, but only indirectly. A lack of uniformity in national technical standards and regulations may have such effects. In service industries such as transport, regulatory policies often operate in a protective way, raising operating costs and prices. Public sector monopolies in production and distribution also restrict entry, as does the protection of domestic labour markets leading to the maintenance of artificially high real wage rates.

Limited and undiversified indigenous production structures with only a few products, and services which can be easily traded across borders, usually underline the limited potential for trade among members of less industrially advanced developing regions. In these instances, supply-side limitations are a more binding constraint on industrial development than the limitations of small market demand. The scope for eliminating high-cost producers and achieving efficiencies is limited when industrialisation among regional members is not sufficiently advanced or technologically competent.

The benefits from increased competition do not result immediately when the region does not have similar ranges of rival products, produced under different cost conditions in different member countries. Resources will not be better utilised through the realisation of scale efficiencies unless industries already exist which need larger markets than those limited to national economies. Nor will efficiencies result unless member countries have been protecting the same industries but with markedly different ratios of factor efficiency in protected industries relative to the same ratios in unprotected ones.

Product Standards and Privatisation

Of the non-tariff barriers to production for regional markets in the developing world, among the most important – especially in the case of land-locked countries where infrastructural links are weak – are additional costs

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created by different national product or service regulations and standards in such fields as transport, health and safety. These add to the costs of production and inventories and distort production patterns. Inevitably, they discourage business cooperation and impede the creation of a unified market.

Product standards are becoming increasingly important considerations in terms of outward-looking policies. For example, European Union standardisation regulations after 1992 now have to be respected by producers wishing to export to that market for a much wider range of products than has previously been the case. The same is the case for NAFTA.

Though the significance of this factor is not easy to establish clearly there can be little doubt that the prevalence of multiple national standards adds to production costs, requires larger inventory holdings, distorts production patterns, discourages cross-border business cooperation by inhibiting subcontracting, and undermines efforts to unify the regional market. This problem has been recognised by several regional organisations in the developed and developing worlds which have undertaken surveys in the specific areas of product and service standardisation.

Another critical barrier arises from the pervasiveness of parastatals, i.e. public sector industries and state trading monopolies which dominate markets in developing countries. The dominance of state-owned enterprises throughout the developing world has been a powerful disincentive to regional cooperation and the design of effective RIAs. Run with national objectives in mind, usually flavoured by political and social rather than commercial considerations, parastatals are not as amenable to cross-border cooperation, or to cross-investment in one another, as are companies under private ownership and management. For example, cross-border cooperation among transport, power, water and telecommunications companies in many developing regions might have occurred sooner had commercial rather than political or security concerns dominated decision-making.

The privatisation trend in developing countries may well lead to more rapid integration of regional enterprises within the same industry, or at least of trade between these enterprises, than if parastatal ownership continued to prevail.[18]

There is a range of other barriers to production where differences are attributable to historical and accidental factors rather than to deep-seated policy

18 Railway and airline operations are two areas where cooperation exists in many regions but is not complete. Road haulage is another service industry in which most developing regions are hindered from operating as integrated areas, usually because of public ownership of haulage companies, as well as a lack of harmonisation of road transit charges and of truck licensing procedures. To the extent that these barriers are motivated by protection, their elimination will confront obstacles similar to those encountered by attempts to reduce other forms of protection.

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or ownership distortions. In such cases, although adjustment costs would be involved in eliminating barriers, it may still be possible to remove the impediments fairly painlessly.

Where export markets are sought outside a given region, harmonisation with the standards of the European Union and/or NAFTA would seem practical. For purposes of regional integration, the *principle of mutual recognition* employed in the European Union might afford an appropriate strategy for many cases, and would not demand harmonisation, though some derogations would doubtless be necessary if this path were to be followed.

Free Labour Markets

The protection of labour markets resulting from domestic political pressures to reduce chronic unemployment in any particular country can be a significant barrier to achieving cross-regional production efficiencies and can lead to regional *dis-integration*, quite apart from worsening a particular developing region's international competitiveness. If existing access to labour markets is denied to workers from neighbouring countries in some developing regions, remittances will fall, as will their purchasing power for consuming the goods and services of the country that imposed barriers.

If under RIAs labour market protection is accompanied by continued restrictions on intra-regional investment flows, the damage to prospects for regional cooperation can be further exacerbated. Apart from the direct effect of reduced purchasing power in neighbouring countries, some form of retaliatory action on their part against protection in adjacent markets might also result in compounding the damage to regional cooperation.

Regional interests can be threatened by political pressures within a particular country or sub-group of countries to maintain artificially high real wage rates. The social dumping argument in the European Union is a case in point. Such pressures pose a serious barrier to any region's achieving international levels of competitiveness in manufacturing or services. Lower real wage rates in different pockets of the same region can often prove a useful equilibrating mechanism to keep overall regional wage rates sufficiently under control, especially in political environments which are subject to strong pressures in the opposite direction.

For this to happen, of course, investment and labour flows across the region (and particularly from high-wage to low-wage countries) must be relatively free and unfettered. Unrealistically high domestic wage rates in some countries set against much lower wage rates in neighbouring countries pose a major policy issue which needs to be dealt with in the regional context. This is becoming a major issue in the European Union and will be even more of an issue in NAFTA as well as in ASEAN.

Barriers to Cross-Border Investment

A major benefit of RIAs in the developing world should be an expanded inflow of foreign direct investment from outside and within the region. To the extent that these two categories of investment depend on the creation of a regional market, cross-border investment will be influenced both by the trade and production barriers already discussed, and by the hindrances represented by investment licensing. The removal of these barriers is a precondition for exploiting the gains from investment under RIAs.

The main obstacles confronting the expansion of cross-border investment in developing regions are exchange control regulations. These regulations can be avoided by using externally held funds or by raising capital overseas. A further obstacle is represented by the underdeveloped nature of financial and banking markets. Domestic capital is perceived to be short (when it is usually misused) and capital markets are generally underdeveloped.

A crucial issue that must be addressed in framing RIAs among developing countries is that of trade-related investment incentives. Some investment incentives take the form of duty drawbacks or rebates, while others take the form of tax holidays. Direct subsidies may also be used. All parties to an RIA have a legitimate interest in the incentives offered by the others, since these may affect the level and location of regionally justified investment in the bloc and thus also affect the direction of trade and the distribution of the benefits of integration. If investment incentives are provided in the context of RIAs, this should be done directly and openly, in a way that does not raise the price of products to consumers. If existing incentives could be shifted to such a basis, one of the major distributional obstacles to operating a customs union would be immediately overcome.

Under RIAs, there must, at the very least, be a willingness on the part of partners to agree on a minimum harmonisation of incentives if the benefits of integration are not to be dissipated in higher costs due to smaller scale production than a regional market warrants. This need not mean complete uniformity of incentives, especially if there are large disparities in the levels of development of members of an RIA. In the interests of ensuring that the benefits of integration are appropriately distributed, it might be appropriate to allow certain countries to offer more favourable incentives, as is permissible in the case of the European Union's own regional policy. Differentiation on such grounds would imply a trade-off between efficiency and equity, but this may have to be accepted as the price of regional accord and to achieve the objective of levelling out.

Because of the intra-regional impact of investment incentives on integration, it may be appropriate for partners in an RIA to harmonise investment incentives as a precondition for access to any trade or tariff

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concessions. Trade agreements being negotiated between various developing countries (e.g. in Africa and Latin America) already contain provisions of a traditional kind, intended to take account of the interests of the participating country in subsidies and incentives offered by partners, but these do not adequately address the issues involved.

Other Barriers

In addition to barriers which affect trade, production and investment distinctly, there are a number of barriers that relate to all three.

- The slowness of convergence among developing economies in different regions in their fiscal regimes, investment incentives, monetary regimes, exchange and inflation rates, acts as a powerful barrier to increasing intra-regional trade and investment. Structural adjustment programmes (SAPs) underway in several developing countries are attempting to correct these macro-imbalances.
- To the extent that such efforts are successful, they may, indirectly, (if inadvertently) achieve a measure of regional convergence. On the other hand, conflicts between national and regional objectives under SAPs may militate against regionalisation because nationally-focused objectives of SAPs may not be compatible with maximising intra-regional trade or welfare.[19]
- Misperceptions of regional opportunity by business communities – especially ethnically concentrated ones in particular regions – could impede rather than accelerate regional trade and investment if predatory rather than cooperative positions are adopted at an early stage.
- Many private businesses appear to perceive enlargement of the regional market in some regions (e.g. South African businesses in Southern Africa or East Asian businesses in Vietnam) as advantageous only because it enables them to compete for aid-funded project contracts and expand aid-funded exports. Establishing more effective long-term business partnerships through investment and joint ventures across borders is not at the forefront of their minds; nor is the prospect of undertaking long-term cross-border investments to capture low labour-cost advantages in contiguous countries. If the early years of business entry into regional markets are characterised

19 This is particularly true of the way in which structural adjustment programmes in Africa have caused an implosion in both public and private investment at the national level (because debt service outflows have been maximised at the expense of domestic investment), and triggered a competitive regional race for commodity exports in each national economy. This has often had a deleterious impact on net export earnings at the regional level, e.g. encouraging farmers in neighbouring countries to increase cocoa, tea, coffee, tobacco, or to increase production of the same mineral commodities simultaneously.

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by predatory behaviour on the part of any single country's or any ethnically identifiable business community (e.g. in Africa and Asia) the immediate reactions of countries will be to raise regional barriers rather than to lower them.

- Domestic policy instability in anchor countries, caused by fiscal laxity to accommodate domestic political pressures, can impede the process of regionalisation. If such instability weakens a particular region's anchor economy the setbacks to regional integration can be significant.[20] When fiscal looseness is accommodated by monetary expansion the negative impact on the regional economy is generally aggravated even further.

Regional integration in the developing world may also be hindered (or promoted) by the present roles and functions of different regional institutional structures. Several such structures exist in the form of: (a) large and well-endowed regional and sub-regional development banks in Asia, Africa, Latin America, the Caribbean and Eastern Europe; (b) various regional economic commissions linked to the UN system which are playing a significant role in promoting RIAs; (c) regional institutions and secretariats set up on a plurilateral basis under specific regional or sub-regional agreements. The latter aim at lowering intra-regional tariff and non-tariff barriers as well as at wider objectives such as administering monetary unions, or achieving infrastructural investment (and operational) coordination in key sectors, as well as broader policy coordination on trade and exchange policies and on monetary policies.

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20 There are two vivid examples of this phenomenon which have occurred recently. The first was the way in which incompatibility between fiscal and monetary policy in Germany, immediately following reunification, and before the all-German national elections, disrupted the region's monetary and exchange regimes and broke the EMS. This happened because the severe monetary squeeze imposed by the Bundesbank to offset the government's fiscal expansion to accommodate unification, resulted in a sharp rise in Deutsche Mark interest rates when most the rest of Europe needed interest rates to decline in the midst of a deepening recession. The strains which emerged in the EMS in attempting to maintain parities under this unprecedented interest rate twist were too great for the system to cope with without very large disorderly changes in parities which were eventually forced by markets. The second example is the case of South Africa in SACU. That economy has been stagnant for over a decade. It complains about the overt costs of compensation and stabilisation arrangements for the smaller members of SACU even though such costs effectively constitute a covert export subsidy for South Africa's manufacturing industry. The cause of economic integration may be severely affected, and extant regional arrangements seriously endangered, if the South African economy goes off-track. This could happen if the new South African government indulges in the same kind of fiscal looseness and accompanying monetary expansion that has occurred in most of the rest of sub-Saharan Africa immediately after independence, to fulfil the unrealistic populist expectations which have been created. Initial signs, however, indicate that it will resist the temptation to indulge in the same type of profligacy.

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This looks all quite well. The problem, however, is that in many cases there are competing institutional arrangements within the same region which all aim at achieving much the same thing. In addition, there are a number of multilateral institutions with global functions (the IMF, World Bank, World Trade Organisation, and the various UN specialised agencies) which have taken an interest in the recent burgeoning of RIAs although with ambivalent perspectives. Duplicative institutional frameworks with overlapping memberships whose bureaucracies (however small) compete for regional attention and pursue different regional agendas cannot facilitate the integration process; they can only confound and confuse it. Hence the overlapping roles and responsibilities of these different institutional players need to be satisfactorily resolved, as does the future evolution of institutional arrangements in different regions aimed specifically at deepening progressively the content of RIAs.

The non-tariff barriers to regional cooperation outlined above identify the most pressing constraints which RIAs presently confront.

The path toward knitting together regional economic communities in the developing world will not be easy, especially under evolving, uncertain economic and political circumstances. Nevertheless, the inevitable emergence of different global economic arrangements makes it incumbent on national governments to ensure that RIAs are negotiated on a basis which benefits both the region and the global economy as a whole. Crucial research issues in examining the future prospects of RIAs in the developing world concern: (a) identifying and understanding fully the effect of non-trade barriers, a subject which has been neglected in the normal literature on integration; (b) devising means for overcoming the defects of past initiatives aimed at removing non-trade barriers and ensuring the implementation of new, more effective initiatives; and (c) stabilising and binding liberalisation measures that are in effect.

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