5 Second-Generation RIAs in the Developing World

In considering the prospects for second-generation RIAs in the developing world and the choice of partners in any RIA, the following determinants merit particular attention: (a) proximity and other geographical characteristics; (b) differences in levels of macroeconomic adjustment; (c) extent of convergence in levels of development and in fiscal and monetary policies; and (d) political attitudes towards accepting binding mechanisms that involve a transfer or pooling of sovereignty. These determinants are taken up below in turn.

Determinants of Success

To achieve significant intra-regional trade expansion, there is substantial evidence that geographical proximity and consequent low transport costs are particularly important factors for RIAs to succeed. Other geographical features, such as natural frontiers, landlocked boundaries, and readily controlled ports of entry, are relevant as well and quite material to the appropriate scope of fiscal jurisdictions and thus to the adoption of customs and fiscal unions, as opposed to other, looser forms of RIAs. These characteristics also illuminate the choice of *natural partners*[24] for each approach in terms of geographical scope, as well as the appropriate time scale and phasing of any process of closer sub-regional integration.

A second prerequisite for effective, beneficial trade-focused RIAs is that participant economies should be sufficiently well adjusted in terms of having achieved micro- and macro-equilibrium so that trade liberalisation is not impeded by exchange restrictions and is undertaken at market-clearing prices. Countries in severe economic difficulties whose structural adjustment programmes are in their early phases of implementation will not be attractive partners in RIAs with more developed and stable countries. Differing time

24 Natural trading partners are only really determined in retrospect and not before the fact when the benefits to members have become apparent as a result of their having highly integrated transport networks, and roughly similar production structures thereby providing scope for efficiency gains to be realised. Some studies suggest that African countries tied together in various regional cooperation arrangements may not be "natural partners" because while countries and borders are organised on a North-South orientation, the natural routes which minimise transport costs are East-West.

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schedules for implementing each country's structural adjustment programme may constrain the speed of trade-focused integration if such differences result in different rates and sequencing of trade liberalisation measures. Significant gains from RIAs can, however, be exploited even by countries that are at different stages of adjustment if such arrangements are focused on capturing gains from sectoral investment and policy coordination. Moreover, it may be possible, by the development of suitable mechanisms, to envisage constructive regional projects being undertaken outside the public sector in anticipation of further regional adjustment.

A third important determinant is the degree of convergence amongst prospective partners across a range of development (and not just monetary, fiscal and inflation) indicators. Conventional wisdom suggests that tight RIAs (which lean toward full integration) will be difficult to implement unless members are at comparable levels of development, since only then would there be a reasonable assurance that all would benefit equally. If, instead, integration takes place between unequal partners, then it will be viable only if effective compensatory mechanisms can be put in place.

Such a view must, however, be qualified. Except in the case of a simple free trade area, successful RIAs anywhere in the developing world will usually demand some form of regional policy to engender equity and accelerate development in underdeveloped parts of the region. Indeed regional policy is a cornerstone of European integration. But focusing on regional equity considerations prematurely may have its own drawbacks, as the case of Africa illustrates.

African RIAs have been concerned with enforcing equity mainly through administrative allocation of preferred locations within the region for new investments and especially for private foreign direct investment. Such an approach – aimed at directing investment flows by fiat – did not induce investors to locate production where governments would like. Instead it had exactly the opposite effect of deterring investment altogether. Even though, on the face of it, the costs of doing investment might initially be higher, foreign investors prefer to locate production in more advanced countries rather than invest in a country with a smaller market and offering poorer infrastructural and business support services.

A fourth determinant of realising the potential benefits of closer integration therefore centres on the crucial issue of *credibility* and *perceived durability* of RIAs, particularly in the eyes of intra-regional investors who have to take a long-term view. Ultimately, such credibility can only be underpinned when member countries are willing to cede powers to regional agencies and are prepared to assure the binding nature of any trade liberalisation, monetary cooperation or other regional commitments that are agreed.

Linking Up with Large Trade Blocs

Another issue that needs to be specifically addressed is whether new types of RIAs should be sought by developing country regional blocs with OECD countries, and especially with the European Union (for developing ACP countries, Eastern European countries and Mahgreb countries) and NAFTA (for developing countries in the Western hemisphere), in order to increase the gains from RIAs within their own regions.

Trade, investment, exchange and payments support are prominent areas where new arrangements for North-South cooperation could usefully be explored, certain aspects of which, unlike the present Lomé arrangements, might call for a measure of reciprocity if they are to attract outside support. The increase in credibility that such cooperation arrangements might engender could be crucial for attracting inflows of foreign direct investment to serve sub-regional markets and, ultimately, even markets beyond the developing region concerned. Additional benefits from greater macroeconomic stability could also be anticipated. In this connection, developing countries should not ignore the significance of initiatives currently under way in the western hemisphere involving free trade areas between North and Latin American countries as well as those in the Caribbean.

These issues need to be urgently addressed by developing countries. Even with multilateral trading arrangements being liberalised and strengthened under the Uruguay Round, the world trading system will be strongly influenced by the practices of three competing large trading blocs. The impact of their evolution on different developing regions will be the result of two opposing forces. On the one hand, to the extent that market unification results in faster growth within those blocs, third countries may potentially benefit through increased markets for their exports, primarily of manufactures. On the other, the creation of more efficient production units within the European Union (EU) and NAFTA, resulting from closer integration, may well reduce the competitiveness of imports from other countries in these markets.

Whether overall demand in the EU and NAFTA for imports from non-member developing countries rises or falls will depend on whether the trade-diverting competitiveness effect is larger or smaller than the trade-expansion effect of faster growth in these two large blocs. Any particular developing region's position in these blocs will depend on the evolution of its relative competitiveness vis-à-vis the position of other developing countries and regions, especially that of the Asian NICs which have already developed significant market share in the EU and NAFTA.

Similar effects may be expected to operate in relation to foreign direct investment, via the investment-creation and diversion effects that will accom-

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pany the completion of the single market in Europe, and the formation of trading blocs in North America, East Asia, Latin America and the Antipodes. Overshadowing all of these are the implications of the further widening of the EU and the development, already under way, of closer links between it and countries of the former East Bloc. Many studies point to the conclusion that these developments will not have any significant immediate impact on most developing regions in terms of their present structures of production and trade. Nevertheless, it can be anticipated that if a particular developing region does not already have entrenched access in EU or NAFTA markets for such products as textiles and clothing, these segments of developed markets will become even more competitive and more difficult to penetrate. For certain other products which might be of importance in the future, the harmonisation and improvement of EU standards will themselves constitute trade-diverting non-tariff barriers from the point of view of different developing regions if they do not take steps to respond. It must not be forgotten either that, in Asia, regional integration is progressing, primarily through trans-frontier corporate integration, aided in some cases by special enterprise zones. New initiatives are under way within ASEAN which can be expected to enhance further the relative competitiveness and rapidly growing significance of the East Asian economies in world trade.

In the face of determined moves towards more effective regionalism elsewhere, a failure to overcome, or reduce, the costs of market fragmentation in regions whose countries have not yet begun to cooperate will mean that those regions, as a whole, will be less well placed in the future to attract the foreign investment, technology and know-how on which they will have to depend for their future economic growth. A good deal of progress must therefore be made in some regions (especially in Africa) merely for them to maintain their present modest relative positions. If, additionally, the countries of these regions wish to prepare themselves to take full advantage of longer-term opportunities, when wage convergence in Europe promises to prompt a further shift of labour-intensive production from its periphery to proximate developing countries (particularly in Eastern Europe and North Africa), then development strategy in these regions will need to be positively shaped and vigorously pursued with those specific opportunities in mind.

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