Trade and Development: Is South-South Co-operation a Feasible Strategy? *

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Abstract

The first part of this article gives a brief overview of the main problems facing the developing countries in the present international trading system, and reviews the debate on import substitution vs. export promotion. Towards this background the main part of the article discusses South-South co-operation as an alternative or complementary development strategy. Global South-South co-operation and collective self-reliance is largely dismissed as an ideologically motivated policy recommendation, overlooking the large number of conflicting interests among developing countries. The areas of joint interest are greater at regional or subregional levels, and a number of South-South integration schemes have been signed during the last decade. There are several potential gains associated with these integration processes, but substantial economic and political barriers have to be overcome. When geographically and politically possible, North-South integration schemes may have larger advantages than pure South-South arrangements.

KEYWORDS: South-South Co-operation, Regional Integration, Trade, Development

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1. Introduction

In 1956 Gunnar Myrdal wrote that the underdeveloped countries' 'way of handling their commercial policy will be one of the most significant factors in determining whether they will fail or succeed in their drive for economic development' (Myrdal, 1956:254). Despite extensive research, however, economists and political scientists have not agreed on which commercial policy to recommend. One reason for this lack of progress is the close and complex linkages between the effect of each country's economic policy and the structural features of the world economy. Radical social scientists have argued that the international economic system is systematically rigged against new entrants, and that a policy of delinking developing countries from advanced nations is necessary. This view has few proponents today, but the idea that global South-South co-operation is imperative to Third World development is still alive, cf. the South Commission (1990) and Panchamukhi (1996). Furthermore, according to UNCTAD (1995) a number of regional co-operation agreements have recently been signed by Third World countries, and studies sponsored by the World Bank speak of a 'new wave' of regionalism (De Melo and Panagariya, 1993a). The signatory parties of these regional treaties are motivated by the belief that co-operation and integration will spur development.

In this article I investigate how various trade policies are expected to affect development. My emphasis is on what the Third World countries can do themselves, and which political obstacles they have to overcome. I start out by briefly discussing the problems facing these countries in the present international trading system. Next, I introduce the question of import substitution versus export promotion, since these competing strategies have dominated much of the development debate so far. The main parts of the article discuss to what extent South-South co-operation in general and regional integration in particular, make up a feasible, alternative or supplementary development strategy. The recent policy debate has been characterised by renewed interest in this issue, and I will review both old and new literature in the field. The focus will be on the general case, not on particular co-operation schemes[1].

2. Problems with the Present Trade Order

The intellectual underpinning of the World Trade Organisation and the GATT agreement is to a large extent classical and neo-classical trade theory. According to this theory all countries stand to gain from participating in international trade. Free trade maximises global output by permitting each country to specialise in what it does best. At the same time trade enables countries to escape the confines of their own resource endowment. The gains from trade may be unevenly distributed among countries, but according to the basic text-book models, no country will be worse off.

The potential benefits from trade are obvious and well-known. Unfortunately, however, the simple liberal approach to trade is not consistent with the historical experience of most developing countries. Although these countries are far from homogeneous, many of them face similar problems under the present trade order, and there are two general reasons why classical and neo-classical theory does not fit reality. First, the theory builds on assumptions that are violated in most international markets. Second, world trade is not, and has never been, genuinely free.

A basic problem with classical and neo-classical theories is the assumption of constant returns to scale and perfect competition. This is far from the actual situation in any economy, a point heavily emphasised by the 'new trade theory' of the last two decades. The prevalence of intra-industry trade, i.e. trade in similar products, is difficult to explain in terms of comparative advantage, and product differentiation seems to be the driving force behind this kind of trade. This implies imperfect competition as each producer has market power in its own varieties. Furthermore, much of the world trade is in oligopolistic industries such as cars, chemicals, electronics and steel. The increasing importance of multinational corporations is another indication that imperfect competition matters, since a key explanation for the existence of such firms is that they have firm-specific advantages to bring to their hosts (Smith, 1994). According to Krugman (1987), the insights of new models incorporating imperfect competition, learning and economies of scale, has reduced the doctrine of free trade from an optimal first best strategy to 'a reasonable rule of thumb'. Note also that Baldwin and Venables (1995) state that the welfare effects of regional integration arrangements 'may be many times larger if industries are imperfectly, rather than perfectly, competitive.'

A related problem is that the theory is static rather than dynamic, with resources assumed to be fixed in quantity. In reality, relative factor endowments and comparative advantages are not given, but in a state of permanent change. Moreover, they not only determine, but are also over time determined by, the pattern of international trade (Todaro, 1992:338). Technology-intensive industries give strong incentives for innovation and opportunities for accumulation of physical and human capital, whereas an economy based on primary commodity production gives fewer possibilities for development. A number of economic mechanisms making the notion of comparative advantage an endogenous phenomenon have been explored in the 'new economic geography' literature, cf. Krugman (1981, 1991, 1995), Krugman and Venables (1995) and Grossman and Helpman (1991: Ch.7 and 8). These new models have given the old theories of uneven development a strong formal justification, and they prove that the issue of optimal trade policies is far more complicated than previously believed by mainstream economists.

Returning to traditional trade theory, resources are not only assumed to be fixed, but also to be perfectly mobile within countries. This is of course not the case, as there can be substantial adjustment costs associated with transferring resources from one sector of the economy to another. Machinery often has limited alternative value, re-education is necessary, and unemployment is a widespread problem. This means that a country which has specialised, cannot without costs withdraw from international trade if its terms of trade deteriorate.

Considering these effects, it is easy to understand that countries which at the moment have their comparative advantages in the production of primary commodities and low-skill intensive industries are sceptical to the long-term consequences of free trade. They fear being locked into a production structure based on low value-added activities. Nearly half the Third World countries earn more than 50 percent of their export revenue from one single primary commodity, such as coffee, cocoa, or bananas (Todaro, 1992:325). In addition to the problems of vulnerability, low value-added activities and small development potentials, these economies seem to have experienced a steady downward trend in their terms of trade over a number of years, although an exact evaluation is theoretically difficult to make (Gilpin, 1987:277). One explanatory factor is the relatively low income elasticity of demand for primary products, and the relatively high income elasticity of demand for manufactured products. Thus, when income rises in rich countries, the demand for food and raw materials from the Third World rises relatively slowly, whereas the demand for manufactures, produced mainly by developed countries, rises quite rapidly. This causes the price of primary products to decline relative to manufactures, and the situation is exacerbated by the propensity of industrialised countries to develop synthetic substitutes for many commodities produced by developing countries. Moreover, with falling prices the developing countries are easily caught in a vicious circle. Trying to maintain their export revenues, they increase their export production and thereby strengthen the downward pressure on prices. The general vulnerability experienced by economies with a small degree of diversification is also aggravated by the fact that primary product prices fluctuate widely. The risk associated with such fluctuations is a real cost not taken into account in the traditional static theory.

Not only do many developing countries depend on few export commodities, but often they also to a large extent depend on one single foreign market, usually the former colonial power. This increases their exposure to risk, and studies also show that countries under such circumstances tend to pay more than the international market price for their imports (Yeats, 1991). This indicates that the competitive pressure on their import prises is low, something which at least partly is due to the lack of infrastructure connecting these countries to each other and the world markets.

Changing focus from market structures to the political aspects of trade, one should note that the present trade regime is not one of free trade. Industrialised countries often have significant barriers to trade in those manufacturing industries where developing countries are most likely to be competitive, e.g. light industries intensive in unskilled labour, such as textiles and footwear. Although the Multifibre Arrangements and other protectionist measures are to be phased out according to the GATT Uruguay Round agreement, to what extent this will actually happen remains to be seen. Lack of administrative capacity is another general problem for most Third World countries. Since many important issues in the field of trade are negotiated in multilateral bodies, this causes developing country interests to be largely ignored when the rules of the international trading regime are determined.

Finally, there are distributive effects of trade not much emphasised either by traditional or by new trade theory. Theories on the political economy of trade policy, on the other hand (cf. Rodrik, 1995a), emphasise that when countries open up to trade, some groups will lose while others gain. When traditional trade theory states that ‘countries’ gain from trade, what is meant is that the gains are large enough to make compensation for the losers possible. However, such redistribution may not be part of the reform. In that case, it is a matter of value judgement whether or not a social improvement has taken place.

3. Import Substitution vs. Export Promotion

Much of the old literature on trade and development concerns whether ‘import substitution’ or ‘export promotion’ is the better strategy. Those in favour of import substitution often view existing trade patterns as a source of dominance and exploitation. Extensive government intervention in the economy and protection in the form of tariffs and quotas are considered necessary to break out of the current world division of labour and to initiate industrialisation and a self-reliant development. Import substitution can also be viewed as a way of saving foreign exchange or as a prerequisite for later export-led growth. The economic rationale for this strategy rests heavily on the infant industry argument. According to this argument, governmental support for an industry may under certain circumstances be justified on a temporary basis to permit high-cost domestic producers enough time to learn and gain sufficient economies of scale to become competitive. From a theoretical point of view, it is not enough, however, to demonstrate that there is a potential for learning and scale economies in a certain industry. For protection to be defensible, the discounted present value of future social benefits must outweigh the efficiency loss during the period of protection. Furthermore, there must be reason to believe that private investors are not able to take advantage of this profit opportunity. Finally, the first-best policy under such circumstances is subsidies, not trade policy measures (Helleiner, 1992:6-7).

Ironically, the new trade literature and the new economic geography literature (e.g. Krugman, 1984) have in some respects given a better formal justification for import substitution strategies than what was available when this policy was most actively pursued. Despite this fact, import substitution is still not recommended by mainstream economists, as it is difficult to find instances in modern times where the strategy has succeeded. It has clearly promoted the growth of manufacturing, but it does not seem to have promoted general economic development or well-being (Krugman and Obstfeld, 1997:257-258).

One of the major problems with import substitution strategies is that the market size of a single country limits the degree of specialisation. In most modern industries there are substantial economies of scale. Without sacrificing product differentiation, these economies of scale can only be exploited fully when producing for a fairly large international market. Another problem is the distortions created by tariffs and other government interventions in the economy. Optimal policies require a large administrative capacity and a strong government to resist the pressure from rent-seeking lobbies, often consisting of foreign firms whose co-operation is necessary in setting up local industries. Neither of these two qualities characterise the average developing country government. Capital intensive industries and production of advanced consumer goods are also often stimulated at the expense of commodities for which conditions are more favourable. Multinational corporations and wealthy nationals are in many instances the main beneficiaries. Moreover, protection reduces the incentives to undertake quality and productivity improvements, and experience shows that infant industries tend not to 'grow up' without a competitive pressure at some stage. Also, import substituting policies usually weaken the agricultural sector and the traditional export industries. Since importing key commodities is still necessary, the result is often balance-of-payment difficulties and increased dependency. If more protective policies are introduced to remedy these problems, the economy is easily caught in a vicious circle. At some stage, then, many countries have been forced to introduce a more outward-oriented strategy in order to earn foreign exchange for debt service and necessary imports.

Arguments in favour of export promotion are to a large extent arguments against import substitution as spelled out above. Advocates of the export promotion strategy stress 'the efficiency and the growth benefits of free trade, the importance of substituting large world markets for narrow domestic markets, the distorting price and cost effects of protection and the tremendous success of the East Asian export-oriented economies of South-Korea, Taiwan, Singapore and Hong Kong' (Todaro, 1992:370). However, it is widely agreed that most countries pursuing import substitution have protected their economies more generally and to a larger extent than the advocates of this strategy would recommend. Furthermore, simply comparing the East Asian 'success stories' with countries pursuing import-substituting strategies does not prove the liberal case. South Korea and Taiwan have been through periods of extensive import

substitution which gave them an industrial base, and in all countries except Hong Kong 'the production and composition of exports was not left to the market, but resulted from carefully planned intervention by their governments' (op.cit.:374). Rodrik (1995b:97) points out that South Korea and Taiwan also had a relatively skilled workforce and a relatively equal distribution of resources. These general conditions were conducive to growth, and the growth was, according to Rodrik, investment-led. Export-oriented policies were only 'important in so far as they enabled a steady rise in imported capital goods'. Moreover, Singapore and Hong Kong are small city states and therefore difficult to compare with other developing countries. For geopolitical reasons, the four 'tigers' also received significant amounts of foreign support, and even though there are obvious benefits from trade liberalisation in many developing economies, there are also large social costs incurred in the transition process. These are easily overlooked.

4. Global South-South Co-operation and Collective Self-Reliance

In response to the difficulties laid out above, various political thinkers concerned with Third World development have advocated the need for greater South-South co-operation. One can argue analytically for such an attitude, but it is clear that this point of view has also been ideologically motivated. Considering the Third World as a group of countries similarly oppressed by former colonial powers and a biased world economy, a call for solidarity and self-reliance comes naturally to mind. Todaro (1992:346) puts it this way:

> While it may not be possible for many LDCs to be self-reliant on an individual country by country basis, some form of trade and economic co-operation among equals is probably preferable to each country trying to 'go it alone' in a world of unequal trade, technological dominance, increasing protectionism among developed nations and various forms of non-market price determination.

Another recent proponent of this view was the South Commission, an independent group of experts and politicians from various Third World countries, stating for example that 'solidarity and co-operation are imperative for the countries of the South' (1990:17).

It was with the establishment of the Non-Aligned Movement and later UNCTAD[2] and the Group of 77[3] in the 1960s that South-South co-operation on a global scale was put on the international agenda. Partly inspired by the success of OPEC in the early 1970s, a New International Economic Order became the main objective, and the United Nations was the natural arena to put forward such demands. With their large voting majority in the General Assembly the developing countries could in principle push through any proposal they wanted. A voting majority and a morally superior position, however, were not enough. By the early 1980s it became clear that the notion of 'commodity power' was not rooted in reality, and Southern demands did not correspond to Southern strengths. Furthermore, the industrialised

countries continuously moved the international economic negotiations away from the UN organisations to the Bretton Woods institutions. These disappointing experiences resulted in little interest in South-South issues for several years. Nevertheless, in the early 1990s, the subject seemed to gain some renewed interest, cf. the earlier mentioned South Commission. A significant change from earlier co-operative attempts has been the far more modest role attributed to the UN system. Moreover, co-operation on a global scale is proposed to start among those countries motivated and financially able, without waiting for all developing countries to join. The latter proposal has been followed by a group of the most industrialised developing countries, the so-called G15 (Folke et al., 1992:40).

South-South trade and co-operation have many potential advantages. By trading more with each other the developing countries will become less dependent on Northern markets and the fluctuations in these markets. Research also shows that South-South trade is different from, and more technology intensive than South-North trade (Sabolo, 1983), thereby helping to industrialise and differentiate the Southern economies. In this way the dependence and vulnerability of the developing countries are reduced. Since the modest level of South-South trade at present has historical explanations, there is also reason to believe that these countries have comparative advantages relative to each other which are not fully utilised. After all, these countries differ widely with respect to resources, technologies and demand. Compared to North-South trade, Southern countries also have the advantage of proximity to neighbouring countries, and it seems reasonable to believe that their goods are in many cases better suited to the needs of other countries on a similar level of development. Increased South-South trade can also protect these countries from what many perceive to be a negative cultural influence inevitable with North-South trade. Furthermore, in theory, commodity prices might be stabilised on a higher level through co-operation. Technology, infrastructure and information are also considered promising fields for co-operation. Finally, shared marketing and distribution may in some industries make it possible to bring the commodities closer to the final customers, thereby increasing profit.

Arthur Lewis (1977:77) was among those who expressed great faith in a strategy based on South-South trade and co-operation, stating that

> the LDCs have within themselves all that is required for growth. They have enough land to feed themselves, if they cultivate it properly. They are capable of learning the skills of manufacturing, and of saving the capital required for modernization. Their development does not in the long run depend on the existence of the developed countries, and their potential for growth would be unaffected even if all the developed countries were to sink under the sea.

This might be true, but it is a regrettable fact that none of the major co-operation efforts have given any substantial results[4]. Lack of support from the industrialised countries and difficulties overcoming the logic of the existing economic order can to some extent explain these failures. One serious obstacle to

South-South trade is transportation. Most international communication lines are North-North or North-South. 'This implies that it is often easier and cheaper to send goods long distance South-North and North-South than much shorter distances South-South' (Folke et al., 1992:232). There are also financial problems, notably the widespread scarcity of foreign exchange. Counter-trade and regional clearing arrangements have tackled this difficulty with some success, but the problem is exacerbated by development aid from the North tied to procurement in the donor countries. A related obstacle is the generous state-sponsored credit terms often offered by exporters from the North. Exporting firms in developing countries and the states backing them are not in a position to compete in this arena (op.cit.). Lack of resources for after-sale services is another problem in South-South trade.

Despite these structural problems, it is recognised that most Third World co-operative initiatives have neither been thwarted by difficulties with the existing economic order, nor by a lack of support from industrialised countries. A World Bank study by Erzan (1989) concludes that 'the structure of tariff and non-tariff protection in most developing countries discriminates against products which could be competitively supplied from other developing countries.' As stated by Cizelj (1983:17), then, there is obviously 'a substantial gap between the declared common interest of all developing countries on one hand, and their everyday operational policies on the other'. He considers lack of solidarity among partners and a preference for domination rather than interdependence to be one important explanation for the failures. As is stressed by many writers, the Third World is not 'one world' but a large number of different countries with different history, culture, level of income, security needs, conditions in the world markets and with different goals. Obviously then, conflicting interests exist, and there is no reason to expect solidarity. A simple illustration is the fact that big and small producers of the same commodity do not easily keep together. Moreover, many of the NICs, such as Brazil, Taiwan and Singapore, are not even members of the Non-Aligned Movement and are often unsympathetic to G77 opinions on North-South issues (Bhagwati, 1984:11). Without full participation from the more developed countries like these, any bid for increased power by the Third World will be fatally handicapped.

The areas of joint interest among partner countries are usually bigger at regional, and especially at subregional levels of co-operation than is the case at the interregional level (Cizelj, 1983:17). Furthermore, the potential advantages from such co-operation are much the same as under global schemes. This makes regional integration an interesting strategy to explore, and particularly so as a wave of 'new regionalism' seems to have emerged over the last decade (De Melo and Panagariya, 1993b).

5. Regional Integration among Developing Countries

The early success of the European Economic Community demonstrated how effective economic integration can be, and prompted many Third World countries to seek similar gains within their own regions. A large number of such regional organisations were formed. UNCTAD (1995), listing subregional, regional and interregional economic co-operation and integration groupings with Third World participation, names 58 such agreements. 50 of these are pure South-South agreements and 47 are treaties at a subregional or regional level[5]. All continents and a very large number of countries are represented on the list.

The records of the various early regional arrangements have in general not been encouraging[6]. In part this is due to what Langhammer and Hiemenz (1990:2) call a 'fallacy of transposition'. Governments of developing countries misunderstood the European process 'as a case of limited co-operation without surrendering national sovereignty, and tried to copy the example in their countries'. However, many initial conditions conducive to integration in Europe were overlooked, e.g. a high level of intraregional trade before integration, similarities in income and industrialisation levels allowing for intraindustry specialisation, corresponding interests in foreign affairs, and willingness and capability to provide compensation payments. Despite difficulties with previous attempts, however, a renewed interest for regional integration schemes has been observed in the 1990s, and 13 of the existing co-operation or integration schemes listed in UNCTAD (1995) have been formed during the last decade. The perceived dynamism of the European integration process probably forms part of the explanation this time as well. Uncertainty about the future of GATT may also have contributed.

The integration process can be classified according to the kind of discrimination removed. Following Balassa (1961) it is common to distinguish between five stages (in Kahnert et al., 1969):

- *a)* the free trade area, which implies the removal of quantitative restrictions and customs tariffs;
- *b)* the customs union, which unifies the tariff of the countries within the area against outsiders;
- *c)* the common market, where all restrictions on factor movements within the area are abolished;
- *d)* the economic union, where economic, monetary, fiscal, social and counter-cyclical policies are to some extent harmonised;
- *e)* the supranational union, where the respective governments abandon completely their sovereignty over the policies listed above and a supranational authority issues binding decisions.

In practice, preferential trading arrangements are also often considered to be a case of integration, at a lower level than free trade areas[7].

An important contribution to the welfare analysis of economic integration was made by Jacob Viner (1950), introducing the distinction between trade-creating and trade-diverting customs unions. Trade creation is the replacement of high-cost domestic production by lower-cost imports from partner countries. Prices will be lowered for consumers and their standard of living increases. On the other hand, previous exporters outside the union still having to pay tariffs may not be able to compete with internal manufactures whose goods circulate duty-free inside the union. This is trade diversion. Consumption may be shifted away from low-cost external suppliers to higher-cost producers in partner countries. From a world welfare point of view, trade creation is considered welfare-increasing while trade diversion is considered welfare-reducing. To what extent trade creation will outweigh trade diversion depends on a number of factors, such as the degree of overlap between goods produced in member states and the degree of pre-union reliance on trade from outside the region (Carl, 1986:6). Viner's conclusion has been much discussed by later economists, and as stated by De Melo et al. (1993), 'the literature is full of "anything may happen" type of results'. Kemp and Wan (1976), however, proved that under perfect competition it is always possible to design a free-trade area which is welfare improving for the member countries and which does not alter the welfare of the non-members. In the spirit of this analysis, De Melo et al. (1993) show that welfare-improving free trade areas can also be designed in the presence of quantitative trade restrictions. De Melo and Panagariya (1993b) argue that this is of particular importance for developing countries, as quantitative restrictions prevail in virtually all South-South integration schemes.

An interesting and important topic is how regional integration arrangements affect non-member countries if one assumes imperfect competition. Baldwin and Venables (1995) investigate this issue and point to what they call 'production shifting' as a mechanism which may have a negative welfare effect on non-members. This occurs because firms inside an integrating region, due to reduced trade costs, get an advantage in partner countries relative to firms in non-member countries. Hence, the profit of firms in member countries increases relative to the profit of firms in non-member countries. This induces entry of firms within the integrating region and exit of outside firms. A similar point is made by Melchior (1997:133) stating that 'integration is a gentle way of prospering at the cost of the others'. The negative effect of integration on outside countries is, however, a theoretical result, and to my knowledge no one has assessed whether it is quantitatively important in a Third World context. Haaland and Norman (1992) and Baldwin, Forslid and Haaland (1996), however, estimate welfare effects of the 1992 European 'single market' on other OECD countries. They find a negative, but modest impact on outside countries. Based on this result, it does not seem likely that much smaller Third World regional arrangements should have an important impact on non-member countries[8]. Furthermore, it is not

obvious that possible negative effects on non-members should be of concern to developing countries trying to improve their economic performance. As stated by OECD (1993:15) 'It does not seem convincing that regional trade liberalisation should be held back because third countries are not similarly outward-oriented.'

6. Potential Benefits of Integration in the Third World

Among potential economic benefits from integration one can distinguish between 'once-and-for-all' benefits from trade liberalisation on one hand, and dynamic effects on the other. Increased trade within the integrating area will improve the resource allocation and create growth. However, most writers seem to agree that the static trade-creating effects of integration are limited at low levels of development. Even though these traditional gains can be of importance in some regions, they are well known and previously discussed. Hence, here I will focus on the longer-run dynamic effects. There are also potential non-economic benefits that can be important.

Foremost among the assumed dynamic economic benefits of integration has been the 'training ground' effect. For many less developed countries, and particularly for those with very small domestic markets, regional economic integration may offer a valuable experience, helping the transition to a more balanced development and a more open economy (Robson, 1987:196). Within a regional setting both quality and marketing techniques can improve and promote diversification and export production at a later stage. A related benefit accrues from economies of scale. 'These economies occur in investment costs, in some types of operating costs and through such phenomena as learning by doing' (Kahnert et al., 1969:128). Integration will increase the market size and where economies of scale are present, reduce the cost per unit. This will benefit customers in the integrated market as well as enhance export production. Note, however, that the training-ground argument is the basic rationale behind infant industry protection and traditional import-substituting development strategies. Even though the argument is important and fits well with new trade theories, a warning can be appropriate. Previous integration schemes, particularly in Latin America, were to a large extent seen as means of making import-substitution less costly in terms of efficiency losses. It is widely agreed that these attempts did not succeed.

According to Thomsen (1994), host country market size is one of the strongest determinants of where foreign firms invest. Hence, by reducing the trade barriers within a region, prospective investors can be offered a larger market, making investments more profitable. This improved ability to attract capital and technology has been another key reason for integration among developing countries (Carl, 1986:6), and the experience of Mexico within NAFTA, and of Portugal and Spain within the EC, demonstrates that integration can have a positive effect on investments (Baldwin and Venables, 1995). Note that the view

on the role of foreign investments has changed over the last decades. Whereas many host country governments and some economists in the 1970s thought that the main effect of multinational corporations was to create monopoly situations which exploited the local economy and hampered development, the mainstream opinion in the 1990s is much more optimistic. Multinationals may have important complementarities with local industry, and a number of econometric studies seem to support the view that foreign direct investment creates knowledge spillovers or demonstration effects which stimulate growth (Markusen and Venables, 1997). In theory, integration should also promote efficiency in the allocation of investments between member countries. However, the harmonised investment climate and increased political and macroeconomic stability resulting from a successful integration process, are probably more important.

Joint production of public goods is another potential benefit since there are often economies of scale in the public sector and some public goods can only be produced by an international community. Strictly speaking, this is in most instances a matter of co-operation, possible without integration, but the close relationship between integrated economies can make it easier for politicians to reach agreements. Traditionally, integration schemes have concentrated on joint production of public services, education, research and physical infrastructure (Langhammer and Hiemenz, 1990:8). An example of this is the East African Community which created a group of corporations to operate the railroads, harbours, post offices and telecommunication systems (Carl, 1986:35). According to the new growth theory, human capital formation is an important factor in explaining growth, and institution-building and joint training therefore seem to be particularly promising fields of co-operation (De Melo et al., 1992:40). With respect to institution building, one should note that existing integration schemes have recently given increasing attention to joint exploitation of deep sea mineral resources, fishing regulations and management of other environmental resources, e.g. wildlife protection (Langhammer and Hiemenz, 1990:8). Defence is another field where there may be large gains from co-operation, but this is likely to take place at an advanced stage only. With respect to customs unions, there are also obvious gains from reduced costs of administrating the countries' customs services. These are often ignored, but can be substantial, particularly for small developing countries (Gunter, 1989:20-21). Moreover, there are substantial savings in reduced paper work for economic agents within the integrated area and for trading partners outside, having to relate only to one regional customs agency instead of one in each of the member countries.

Another benefit from the public domain is that regional commitments may help to discipline the domestic political opposition. Policies, e.g. sector specific tariffs or subsidies, which may benefit relatively small, but well organised interest groups at the expense of the majority, can be shifted to

supranational bodies (op.cit.). Other public tasks can in effect become more decentralised. Corruption is a devastating problem in many Third World countries, and Shleifer and Vishny (1993) argue that political competition, i.e. a system where several agencies provide the same service, can reduce the level of corruption. Economic and political integration may be one way of creating such a system. By harmonising regulations, various licences can be mutually accepted across national borders. Charging bribes will then become more difficult since economic agents being asked for an illegal fee have the possibility of obtaining the licence elsewhere.

Reduced vulnerability has been an important rationale for increased South-South trade in general, and this argument is valid also on a regional basis. The effect can be somewhat reduced by the fact that neighbouring economies usually have similar features and might therefore move through booms and slumps together. However, this may be compensated by improved availability of resources and a more secure market access under a successful integration scheme as compared to a global system of trade preferences. The formation of regional integration arrangements are by Hindley and Messerlin (1993:360) interpreted as 'insurance policies against an uncertain and threatening future', i.e. a future with increased protectionism. Even though the future may seem less threatening after the closure of the GATT Uruguay Round, protectionist forces are still strong in the major markets. Furthermore, the general problem of dependency has not changed. Improved bargaining power is therefore another argument for regional integration among developing countries. Larger economic units have more power in the international community, but too much should not be expected at this level. Even though groups of countries may have a stronger voice than individual countries, the impact of the Third World is in any case limited, as demonstrated by the debate on the New International Economic Order during the 1970s. With respect to negotiations on tariff concessions, though, better deals might be possible as larger markets are more attractive than small markets. Furthermore, by pooling resources, better expertise can be devoted to such negotiations. Cartelisation is another possibility. Neighbouring countries tend to belong to the same climatic belt or geological area, and therefore often export the same commodities to the world markets. However, although maintaining cartel discipline might be easier on a regional than on a global level, it is still known to be difficult. Moreover, usually there are other producers or potential entrants outside the region further complicating the policy. A more promising field is for integration to strengthen the bargaining power vis-à-vis multinational corporations. Harmonisation of incentive structures and tax policies may enable member countries to avoid loss of income to such corporations arising from competitive tax concessions which they offer in their bid to attract foreign direct investment (Balasubramanyam, 1989:181). The discipline problem may be less in this area as tax structures are not as easy to change as export volumes.

Puga and Venables (1996) analyse South-South regional integration formally, drawing on the new economic geography literature. In the model of Puga and Venables there is imperfect competition with four forces determining profitability and thereby the location of firms. First, a large number of manufacturing firms in a country or location drive up wages. Second, given some trade barriers, a large number of manufacturing firms drive down product prices. These are standard neo-classical forces that induce firms to locate where industrial activity is low. Third, however, being in a developed location means that one has easy access to specialised intermediate inputs because of the large number of firms in the same location. This reduces costs. Fourth, demand is larger in a developed location, and this also increases profits. These cost and demand linkages are pecuniary externalities which induce firms to set up in the same location as existing firms. Knowledge spillovers and access to specialised labour are other cost-reducing effects of being located in a developed area. If such forces are powerful compared to the neo-classical ones, this may explain why we observe agglomeration of manufacturing in a subset of countries, and it means that if a development process gets started, it might become self-reinforcing. Within this framework, unilateral liberalisation will on the one hand increase product market competition from foreign firms and reduce profits. On the other hand, intermediate inputs can be imported more cheaply, something which increases profitability. In the model of Puga and Venables (op.cit.), the last effect dominates and unilateral liberalisation will help industrialisation.

Turning to South-South integration, still within the model of Puga and Venables, this will also induce industrialisation, but through a different mechanism, namely through increased local demand[9]. Whether unilateral liberalisation or South-South integration is the better strategy depends on the strength of the forward linkages resulting from cheaper imports, compared to the increase in demand resulting from integrating into another Southern market. Simulations on their stylised model indicate that South-South integration is better than both unilateral liberalisation and South-South integration combined with liberalisation. These results are based on several assumptions, most notably that the Southern economies are not too small. This simply imply that creating a large 'home' market is critical to the success of integration, and when a sufficient market size cannot be achieved, protection should be very modest. The reason for this is that most of the production will have to be exported if the integrated market is small. Protection and thereby reduced competition will then only have a minor effect on profits, whereas access to cheap imports is still as important. The analysis, however, also shows that from the point of view of a Southern economy, South-South integration is inferior to North-South integration, and I will return to this below.

A positive effect of integration, not mentioned above, is that it can speed up adoption of new technologies by the least developed regions or countries. Furthermore, it may give these members access

to more advanced institutions and policy instruments. This can of course take place within South-South integration schemes, but the potential for technology transfer is much bigger within integration schemes involving both developing and developed countries. North-South integration is rare, but De Melo et al. (1992), studying NAFTA, find evidence of such 'catch-up' effects. At first sight, this may seem to counteract the analysis of Puga and Venables (1996) as agglomeration forces in their model draw firms into already developed countries. These agglomeration forces, however, are strongest at intermediate levels of trade barriers, and it is presumably such 'intermediate levels' of barriers that account for the present unbalanced location of industries between North and South (cf. also Krugman and Venables, 1995). The intuition behind this is that when trade costs are prohibitive, economic activity will have to be spread out. As trade costs are reduced, taking advantage of the positive externalities associated with agglomeration becomes more attractive, and a circular process leading to regional differentiation starts. When trade costs are further reduced, however, factor price differences will at some point start to dominate, and the periphery will again become industrialised. Regional integration between developed and developing countries corresponds to trade barriers being reduced from an intermediate to a low level, and as mentioned above, Puga and Venables' simulations indicate that North-South integration, if possible, is better than South-South integration from the point of view of the Southern economies. Within their framework, the driving forces are improved access to large Northern markets and improved supply of intermediate goods due to lower tariffs. These forces are offset by increased import competition in the domestic market, but the overall effect is positive.

According to the model simulations of Puga and Venables North-South integration may be welfare-reducing for the Northern countries. This, however, is not a general result, and besides, these countries may lose more by staying closed while the Southern economies liberalise amongst themselves. Furthermore, a smaller wage difference between North and South is likely to reduce the migration pressure and hence be attractive to Northern countries on that account. Whalley (1993) and Winters (1993) add to this subsidiary objectives such as increased political influence and the adoption of advantageous institutions by Southern partners, e.g. with respect to environmental protection.

7. Barriers to Integration

The strategy of regional integration may look good on paper. As mentioned earlier, however, the progress and achievements of most integration schemes among developing countries have been less than satisfactory. Langhammer and Hiemenz (1990:13-17) make a distinction between natural barriers, political barriers, economic barriers and politico-economic barriers. Natural barriers may be rooted in geographic conditions or historical developments and have in common that they are constraints to integration outside the responsibility of partner countries. Transportation costs, or communication costs

in general, are important examples. Differences in language and culture can also complicate the integration process as well as different legal and administrative traditions. Difficulties of integration across anglophone and francophone areas in Africa illustrate this. Such barriers are not prohibitive, though, as demonstrated by the European Union.

Many of the natural barriers can clearly be traced back to the colonial era, but this heritage may also help integration among neighbouring countries having been part of the same colonial empire. The relatively most successful integration schemes have been those which could sustain the integration level inherited from the colonial period, such as the West African Economic Community and the Central African Customs and Economic Union (op.cit.:18). On the other hand, many developing countries are in the process of finding a national identity. Such a search for identity can constitute a political obstacle to integration. This applies particularly to African and Asian countries which have aimed at neutralising problems of multiracial and multitribal societies through a common umbrella of a national state (op.cit.:14). The tensions and numerous military conflicts between many developing countries are obviously also a devastating barrier to integration, whether they are rooted in nationalism, strategic considerations or both. Differences in ideology or economic philosophy can also be a major obstacle as was shown in East Africa in the case of Kenya and Tanzania (op.cit.:15) or within the ASEAN, particularly between Singapore and Indonesia (Balasubramanyam, 1989:177).

The most important barriers to integration are probably at the economic or 'politico-economic' level. A quantitative assessment of gains and losses of integration from a national point of view is very difficult to make as considerable conceptual and practical problems are involved. Unfortunately the losses are more tangible and immediate than the gains which first materialise during the course of the process (Folke et al., 1992:117-118). Delayed or postponed reductions of trade barriers between integrating economies are therefore among the most important reasons why Third World integration schemes have failed (De Melo et al., 1992:5), and disputes over the location of industry and design of compensation schemes for perceived losers in the arrangements have been quite common (Puga and Venables, 1996). Both experience and the theories of new economic geography show that liberalisation of trade may accentuate existing inequalities. In regional groupings where the distribution of industries has been left to the market forces, development has tended to favour regions and states with relatively high per capita incomes or relatively large domestic markets (Robson, 1987:201-202). This is exactly what the theoretical model of Puga and Venables (1996) predicts. Under all integration schemes analysed, one of the two Southern economies in their model industrialise before the other, but the resulting differences are transitional if the integration process is taken far enough. It means, however, that a strong momentum is needed to get the process started, and that the various steps should be carefully planned so

as to start out with integration projects whose benefits are visible at an early stage. Furthermore, one should explicitly identify allies and pressure groups which are in favour of integration (Vaitsos, 1978:744) and try to compensate groups who stand to lose.

Even if liberalisation and integration do not cause poor regions or countries to become poorer in absolute terms, different growth rates between neighbouring countries can also be an obstacle. As argued by the realists, individual well-being is not necessarily the key interest of states. Instead, 'survival and independence constitute their core interest' (Grieco, 1990:39). Driven by these interests, states are acutely sensitive to erosion of relative capabilities. If the realists are correct, and they probably are to some extent, states are 'defensive positionalists' and this 'may act as a constraint on the willingness of states to work together even in the face of common interests' (op.cit.:40). The reason is that 'increasingly powerful partners in the present could use their additional power to pressure them or, at the extreme, to become all the more formidable foes at some point in the future' (op.cit.). Politicians might also evaluate integration on the basis of their own utility and for example bend to the demands of their own electorate, possibly at the expense of national welfare (Langhammer and Hiemenz, 1990:16).

Distributive difficulties are exacerbated by lost government revenues resulting from the elimination of intra-union tariffs. Customs duties may account for a large portion of total government revenues, particularly in the least developed countries, and experience has shown that 'integration will not work unless some compensatory mechanisms are built in to help the poorest member states' (Carl, 1986:20). Several devices can be and have been used for this purpose. From a theoretical point of view, income transfers, e.g. through development banks, would be the best instrument. According to Vaitsos (1978:749), however, fiscal compensation has proved neither appropriate nor politically acceptable. Regional industrial policy and agreed specialisation is another possibility, but the record of governmental industrial planning is not the best. A final possibility is investment programmes in infrastructure, technology assimilation, development of managerial and technical skills, marketing studies and so on (Vaitsos, 1978:749). Bjorvatn (1998) points to improved quality of infrastructure as a particularly promising policy to promote regional equality. It is also important that liberalisation schemes include not only the manufacturing sector, but agriculture and raw materials, too, since these are the sectors where backward countries have their largest potential for short-term expansion.

8. Conclusion

Trade can increase welfare and strongly stimulate growth, but unilateral liberalisation is not likely to have all the advantages described by traditional trade theory. The development process cannot meaningfully be viewed as a case of comparative statics, as there is a danger that less developed

countries will be locked into a production structure based on primary commodities with little potential for innovation and growth. On the other hand, strong and long-term protection is even worse than unilateral liberalisation and has proved to be a serious impediment to development in many countries. Various forms of South-South co-operation have been considered a middle way between these two development strategies. With respect to general South-South co-operation, a pragmatic and selective approach seems to be necessary. The developing countries are too different and have too many conflicting interests for global South-South co-operation and collective self-reliance to be a viable strategy. Regional integration is a more promising and realistic strategy, even though integration, too, is a process fraught with tension and conflict. The dismal results of previous integration schemes have not primarily been due to a misunderstanding of the potential benefits. The main problem seems to have been a lack of will to implement the necessary policies, and there are several lessons to learn from these earlier efforts. First, regional integration is not an alternative to trade with the rest of the world, and it cannot offset the disadvantages of an excessive import substitution strategy. Second, some groups will lose out in the integration process, and the advantages are mainly long term, particularly for poor countries. Resistance from various interest groups and poor regions should therefore be expected, and one should actively seek allies in favour of the process and start with projects having visible positive effects. Compensation schemes for weaker partners are also of utmost importance. Third, there might be catch-up and stabilising effects for developing countries integrating into developed country markets if this is geographically and politically possible. In cases not ready for integration, there can be significant gains from regional co-operation, and such co-operation should also be stressed within ordinary integration schemes. Infrastructure, education, research, environment, defence, international negotiations and regulation of the multinational corporations are all promising fields in this respect.

Notes

1. Cf. OECD (1993) for an evaluation of the historical experience with specific regional trading arrangements among developing countries. For studies evaluating future prospects of integration in particular regions, cf. part II of De Melo and Panagariya (1993a).

2. UNCTAD is the United Nations Conference on Trade and Development. It was established due to Third World dissatisfaction with the post-war international economic arrangements of the Bretton Woods system. The first conference was held in 1964. Between the periodic conferences held every three to four years, day-to-day activities are handled by the UNCTAD Secretariat. A recent result considered important by the proponents of a global South-South strategy is the GSTP agreement labelled 'a historic event for the Third World' (Linnemann, 1992). The idea of a 'General System of Trade Preferences' among developing countries was formally proposed to form part of the Economic Co-operation among Developing Countries (ECDC) program in 1976. The agreement became effective in 1989. However, the trade liberalisation implicit in the first round of negotiations within the GSTP was not very significant. 'As of now, the GSTP is largely of symbolic value' (The South Commission, 1990:175).

3. The G77 originated at the 1963 session of the UN General Assembly where a 'Joint Declaration of the Developing Countries' was signed by 75 countries. Membership has increased far beyond 100, but the group became permanently named the Group of 77.

4. With respect to trade volumes, South-South trade can roughly be divided into three periods (Folke et.al., 1992:18-20). Between 1945 and 1972 South-South trade grew in absolute terms, but decreased in percent of world trade. Between 1973 and 1981 it also grew in relative terms and regained former importance. After 1981 its relative importance decreased once more, mainly due to the debt crisis and declining revenues from oil exports which also reduced the momentum created by the OPEC member states. In the late 1980s, however, South-South trade expanded again, owing to the continuous growth in the NICs. According to UNCTAD (1995) South-South trade accounted for 9.7 percent of total world trade in 1992. 38.8 percent of total Southern exports went to other Southern countries, and 37.5 percent of total Southern imports came from other Southern countries.

5. Historically, the Latin American countries have had the most positive view on preferential treatment of neighbouring countries. In Latin America regional integration was mainly intended to surmount the limits to import substitution. Sub-Saharan Africa had a completely different point of departure. These countries had at the outset a high level of institutional integration since large colonial entities sharing language, tax system, tariffs, currencies, infrastructure etc. had been split into politically independent units. At independence, these economies were fragile and threatened by the priority of new governments for national autonomy. In the Middle East and Asia the situation was again different. Here, extreme heterogeneity of the countries with respect to market size, resource endowment and level of income as well as conflicting religious and political systems, made common targets difficult to define (Langhammer and Hiemenz, 1990:1). According to Cizelj, writing in 1983, more than 80 developing countries were involved in about 30 integration processes at that time. Martin (1992:73) counting regional integration schemes as well as regional co-operative institutions in Africa alone, estimates the number to be more than 200.

6. De Melo and Panagariya (1993b) find that only five among the many South-South arrangements signed during the 1960s had a share of intra-regional exports in total exports above four percent, whereas all North-North arrangements came above this threshold. Furthermore, only one of the South-South arrangements experienced a noticeable, though temporary, increase in intra-regional exports.

7. Note that all integration schemes run against the most-favoured-nation clause of the GATT Article I. However, prohibition of regional integration was not considered desirable, and such schemes were instead considered a 'supplemental, practical route to the universal free trade that GATT favoured as the ultimate goal' (Bhagwati, 1991:66). The GATT article XXIV, therefore, provides an exception to the non-discriminatory principle in Article I for free-trade associations and customs unions. One argument in favour of this is according to Blackhurst and Henderson (1993:410) that trade liberalisation in a geographic region which includes several countries resembles the elimination of barriers to trade between the states or provinces within a country. In both cases closer regional integration in itself does not make

the region less integrated with the rest of the world, hence it cannot be considered an inherent threat to global economic integration. There appears, however, not to be any consensus with respect to whether regionalism aids or counteracts multilateral efforts to achieve free world trade. Those sceptical towards regional integration fear that it implies a fragmentation of the world economy into competing trade blocks (Bhagwati, 1993).

8. This is not to say that regional integration among industrialised countries may not have significant negative effects on developing countries, a widely held concern which was evaluated by OECD (1993:91). The report concluded, however, that the ‘contention that regional trading arrangements are leading to increasingly regionalised trade is not born out by the data ... for the developing country groupings, regional trade with the highly economically integrated regions - the OECD regions - has been the most stable of all.’ This was based on an analysis of data from 1966 to 1989, but it does of course not prove that other harmful effects than reduced trade may not exist. A further investigation of this issue is beyond the scope of this article.

9. Cf. Bjorvatn (1998) for a different economic geography model formally analysing South-South economic integration. Bjorvatn shows that reduced transportation costs foster regional balance in economic activity and income.

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