

Regional Integration in Southern Africa: Motor of Economic Development?

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In late 2000 member countries of the two leading Regional Integration Arrangements (RIA) in Southern Africa – COMESA and SADC² – started to abolish the remaining trade restrictions within each RIA. By the end of this decade they will have created Free Trade Areas, which will be accompanied by other substantial modes of economic integration and harmonization. Like their prominent counterparts in other regions of the world – EU and NAFTA or the envisaged Free Trade Area of the Americas – Southern Africans want to provide their economies with a substantial growth impetus by deepening their regional integration. Though, the region itself consists of a messy cluster of different overlapping multi- and bilateral trade arrangements.

Since the early nineties we experienced a boost in the number of RIAs, which traditionally have worked best among high-income countries. In Southern Africa the RIAs are predominantly among low-income countries or between (relatively) high-income countries and developing countries. Do these kind of RIAs also foster economic development of their member countries? Where do the economic benefits of a

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² Common Market for Eastern and Southern Africa; Southern African Development Community.

regional trade agreement generally come from – especially when there are so many overlapping arrangements? As regional integration will lead to a relocation of economic activities, do we expect to see more of interregional trade creation or is there a danger of diversion of economic performance? So, which of the liberalizing countries is more (or less) likely to profit welfare wise? Hereby, the past and future enlargement of the European Union provides us with substantial insights.

Based on theoretical work on preferential trade areas and the respective empirical evidence, we will provide answers to the questions stated. First, we briefly describe the theoretical and empirical linkages between international trade and economic growth. In part 2, we present graphical models of free trade areas and customs unions as well as one that captures economies of scale and imperfect competition. All of them are addressed to the Southern African context, whereby South Africa as the major and most industrialized economy of the region is given special emphasis. The third part of the paper discusses the benefits and costs of RIAs based on simulation and empirical studies for various regional trade agreements. Part 4 presents the overlapping RIAs in Southern Africa and discusses the advantages and drawbacks of a cluster of RIAs. Finally, we will emphasize the political alternatives for South Africa derived from our theoretical models.³

1. ECONOMIC GROWTH THROUGH INTERNATIONAL TRADE

³ Our analysis extends the previous work of McCarthy (1999).

Why do we briefly reflect the effects of international trade on economic growth? As it is widely assumed that RIAs increase the trade activities between the partner countries at large, it is useful to state the various channels through which the increased exchange of goods and services might effect the standard of living of these countries.

The well known export(trade)-led growth hypothesis underlines the positive effects of export revenues on economic growth: (i) export revenues provide the necessary *foreign exchange* to overcome the foreign exchange bottleneck, enabling the country to import the necessary capital and intermediate goods as well as increasing its capability to finance its debt service. (ii) *Resources are allocated according to the comparative advantage* of a country. This will enhance its productivity and will induce more efficient investments. (iii) Stronger exposure to *international competition* through larger volumes of exports and imports increases the pressure on the exporting industries as well as import competing sectors to keep costs low. This again provides an incentive for the development of new technologies, i.e. product as well as processing innovations (Emery 1967:471). (iv) For countries with small domestic markets export production becomes an essential part of achieving *economies of scale*. (v) *Spillover effects* due to externalities generated by exports as well as imports enhance a country's labour and capital productivity.⁴

⁴ One can distinguish know-how and technological spillovers; e.g. the foreign contribution to the local stock of knowledge increases with the number of interactions between domestic and foreign agents (Grossman/Helpmann 1990; Romer 1986).

The latter three channels – increased competition, economies of scale and spillover effects – document the *dynamic gains* through trade. Over the long-run these dynamic gains are much more important mechanisms by which integration into the world economy enhances economic growth. Through its trade policy, a government can try to lock in those positive effects or they might deliberately introduce a protectionist strategy to shield existing and newly founded domestic industries from foreign competitors. Prebisch (1950) and Singer (1950) labeled such a policy *import substitution* as a mean for the industrialization of developing countries. Most of the LDCs – including the countries of Southern Africa – implemented these inward-oriented policies after the second world war. South Africa actually started already in the mid-twenties to implement protectionist measures. Since the eighties more and more LDCs introduced outward-oriented trade policies, trying to overcome the detrimental effects of protectionist policies that have been in place for so long. Here, we have to clarify an often stated misconception: outward-orientation – sometimes also called export-orientation – is in most instance a trade policy with relatively neutral production incentives. It does not privilege export production (Balassa 1978:181). Whereas, inward-oriented trade policies lead to an inefficient allocation of factors of production and the problem of rent-seeking. In the case of *South Africa*, even though the government introduce export promotion schemes in the 1970ies and 1980ies to strengthen manufacturing exports, the bias against export production remained significant. To a lesser extent this bias continued to hamper export growth during the last ten years, when the

new democratic government implemented substantial reductions in the levels of protection on the way to reintegration into the world economy (Lewis 2001:4-5).

Empirically, the relationship between economic growth and various trade variables - export growth, trade shares, trade orientation - has been tested regularly over the last 30 years by either cross-country or country specific studies. The results show almost unanimously that there is a significant positive correlation between GDP growth and exports/trade as well as outward-orientation.⁵ The direction of causality nevertheless, is often disputed between economists. Though, more recently Frankel and Romer (1999:394) showed that even when you take geographical factors into account trade (share) still raises income significantly by „spurring the accumulation of physical and human capital and by increasing output for given levels of capital.“⁶

Even for *South Africa*, which implemented protectionist trade policies to develop a domestic manufacturing sector and since the mid-seventies was held down by trade and financial sanctions, did exports exert a moderate, significant positive influence on economic growth. Over the same period of

⁵ e.g. for cross-country studies: Balassa (1978), Kormendi/Meguire (1985), Dodaro (1991), Edwards (1991), Lee (1993), Frankel/Romer (1999), Burnside/Dollar (2000). Barro (2001:14) showed that the positive growth effect of openness (trade share) diminishes as a country gets richer. So, for the poor Sub-Saharan African economies increased openness is a goal worth while pursuing..

⁶ They estimated for a sample of 150 countries in 1985 that a one percent increase in trade shares will raise income per person by up to two percent (Frankel/Romer 1999: 387).

1945-1990, trade distortions had a small negative impact on income growth. Despite a considerable export bias for manufacturing industries, the positive influence of exports on growth can be attributed to the large export shares of natural resources and its processing industries (Piazzolo 1995:315). On a sectoral basis, due to the export bias as well as to sanctions only five out of 27 manufacturing industries experienced a significant positive cointegration relationship between growth of exports and Total Factor Productivity - TFP - within the period of 1972-1990 (Piazzolo/Würth 1995:186). For the following 1990-1997 period, in which the export bias had been significantly reduced, Jonsson and Subramanian (2000:29) showed that increased openness accounted for close to 90 percent of the actual TFP growth of 24 manufacturing sectors.

In several of the cross-country studies, regional dummies were included to take into account variations of income developments due to the location of a country. All of them resulted in generally significant negative coefficients for Sub-Saharan Africa.⁷ Concerning our specific task in evaluating the growth effects of RIAs, Vamvakidis (1998) tested this relationship in a cross-country study for the period 1970-1990. Additional to the usual set of variables like investment, education, trade share, openness and initial per capita income he included the following five RIAs: Association of South East Asian Nations (ASEAN), Andean Common Market (ANCON), Central American Common Market (CACM), European Union, and Union Douaniere et Économique de l'Afrique Centrale (UDEAC). Except for the European

⁷ e.g. Lee (1993:323), Burnside/Dollar (2000:854).

Union, all of them are South-South RIA; i.e. integration agreements between LDCs or Emerging Market countries. No major Southern African integration arrangement was included as they didn't exist during the full period of consideration.⁸ Interestingly, in only one model specification did the EU show up as exerting a slightly significant positive effect on per capita GDP growth. The moment Vamvakidis (1998:264) controlled for openness, even the EU dummy became insignificant. The other four RIAs never had a significant impact on growth. He states that especially the South-South RIAs were designed to *divert trade*, as part of their import substitution policies during the era of analysis. Only when there is room for *trade creation*, would one expect a positive impact on per capita income. So, is that the end of our story?

No - based on his other findings, we can state that if a RIA increases the openness of the large and more developed countries toward less developed members, it should promote their growth (Vamvakidis 1998: 265).⁹ Especially, the more recent North-South RIAs fulfill exactly these prerequisites. At the moment, it is still too early to test their effects on growth in a cross-country setting.

⁸ He could have included the much older Southern African Customs Union (SACU). But economically SACU is almost equivalent to South Africa as the four other partner countries are so small in size (3,8% of South Africa's GDP).

⁹ Frankel/Romer (1999:394) also estimated that by „increasing a country's size and area by one percent raises income by one-tenth of a percent or more.“

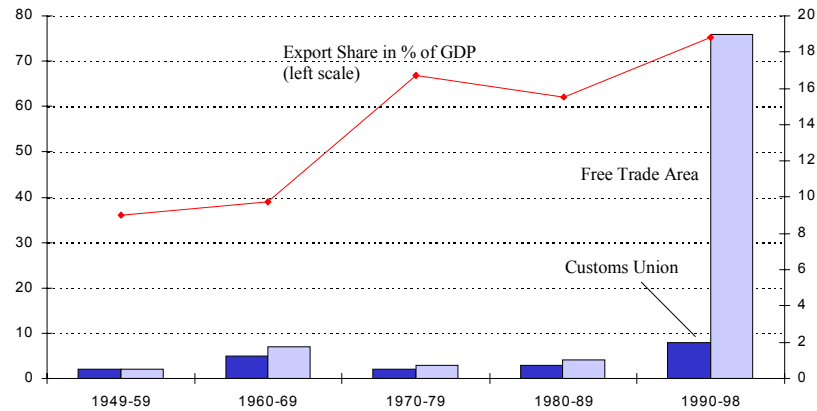


Figure 1. Number of Regional Integration Arrangements (1949-1998)
Source: Schiff (2000).

Considering the surge in the formation of RIAs during the 1990ies (Fig. 1), this also will not be an easy task. The rapid surge of new RIAs is probably due to the fact that multilateral trade liberalizations through WTO has come to almost a halt. Therefore, countries turned to the second-best policy of liberalizing trade within regional groupings.

2. MODELLING REGIONAL INTEGRATION ARRANGEMENTS
As the two major Regional Integration Arrangements in Southern Africa – COMESA and SADC – are aiming eventually at a Customs Unions (CU) respectively a Free Trade Area (FTA), we will take a look at these two kinds of RIAs from a theoretical perspective. Relative simple graphical tools will be applied, but they should be sufficient enough for us to derive some major general findings. Our models are based on their more general presentations in Panagariya (2000). Both, an FTA as well as a CU are Preferential Trade Areas. While a Preferential Trade Area refers to a union of

several countries in which lower tariffs are imposed on goods produced in the member countries than on goods produced in the Rest of the World (ROW). An FTA eliminates tariffs entirely on goods produced in member countries. A customs Union harmonizes tariffs ever more, by all members imposing a common external tariff on a given good.

a. Customs Union

Lets us graphically depict a CU between South Africa and Zimbabwe in the Footwear industry (Fig. 2). By looking at the price range of interest, close to world prices (ROW), we'll see that South African suppliers will not live up to domestic demand. The South African Footwear imports are therefore supplied either by manufacturers from Zimbabwe or the ROW.¹⁰

¹⁰ Net South African imports of section 12 (harmonized system), of which Footwear are the most important sub-category, amounted to R 1.04 bn in 1999; South African producers exported only R 143 m. 7% of South Africa's Footwear imports are supplied by Zimbabwe (SARS 2000).

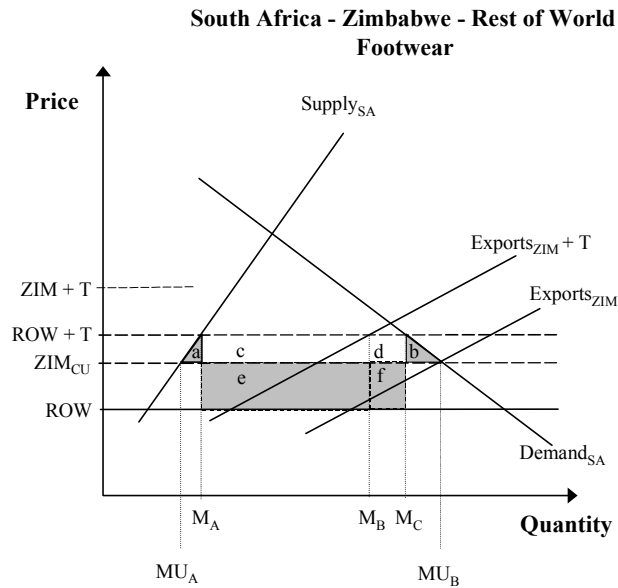


Figure 2. Customs Union

As Zimbabwean producers are less competitive than their counterparts from ROW – e.g. Southeast Asia, at world price levels their share in South African imports is relatively small. Though, South Africa levies a tariff (T) on Footwear imports from all countries. Due to this tariff rate, South African Footwear production increases and domestic demand declines as Footwear price rise to $ROW+T$. Additionally, we assume that ROW manufacturers face infinite supply elasticities, while Zimbabwean ones are modelled with finite supply elasticities. At a price level of $ROW+T$ South Africa imports shoes in the amount of (M_B-M_A) from Zimbabwe and (M_C-M_B) from the Rest of the World.

Now that Zimbabwe and South Africa have decided to form a customs union, the export supply curve of manufacturers of the neighbouring country shifts outward to $Exports_{ZIM}$. Therefore, the supply of Footwear from Zimbabwe increases as there is no tariff levied on Zimbabwean imports within the CU. The external tariff (T) for ROW suppliers remains in place. In this extreme example, Footwear price within the CU drop to ZIM_{CU} with no additional imports from the ROW. Two major effects on trade can be identified:

- (i) *trade creation* due to the fall in Footwear prices for the CU. In Figure 2, this effect is depicted by the area of the two triangles (a + b).
- (ii) *trade diversion*, as South Africa imports no more shoes from the rest of the world, but from Zimbabwe only. The previous imports from ROW ($M_C - M_B$) are substituted by Zimbabwean ones.

While trade creation enhances the welfare of an economy, trade diversion does not increase the economic wellbeing as the country just shifts the source of imports from the ROW to a CU member country.

Let us take a closer look at the various welfare effects that are imposed through the customs union on the two member countries and the rest of the world:

- (i) *South Africa* – consumer surplus of the importing country increases by the areas (a + b + c + d) due to a drop in the domestic Footwear prices. Government revenue (e.g. tariff revenue) declines by the four rectangles (c + d + e + f). Therefore, the net effect for South Africa is determined by comparing the areas (a + b) with (e + f). South Africa will only end up

with a positive overall welfare effect, if the inefficiencies of Zimbabwean manufacturers compared to the ROW ones are relatively small.

- (ii) *Zimbabwe* – as export production rises substantially, Zimbabwe will gain additional producer surplus.
- (iii) *Rest of the World* – export production will decline due to trade diversion; ROW ends up with a diminished producer surplus.

b. Free Trade Area

Instead of introducing a common external tariff (T) on Footwear imports from the rest of the world, Zimbabwe and South Africa agree upon a less harmonized trade integration. They only eliminate (internal) tariff rates on goods produced in the partner country. Let us assume that South Africa levies a higher tariff rate (T_{SA}) on imported Footwear than Zimbabwe (T_{ZIM}). Figure 3 presents the graphical analysis for an FTA within the SADC context. As for the case of a customs union, Zimbabwean manufacturers are less competitive than ROW producers. Therefore, the domestic price level for shoes in South Africa is determined by world price plus the South African tariff rate: $ROW + T_{SA}$. This tariff is also imposed on Footwear imports from the neighboring country. Before they form an FTA, the finite supply elasticity leads to a Zimbabwean export supply of $Exports_{ZIM} + T_{SA}$. South Africa imports in the amount of $(M_B - M_A)$ from Zimbabwe and $(M_C - M_B)$ from the Rest of the World.

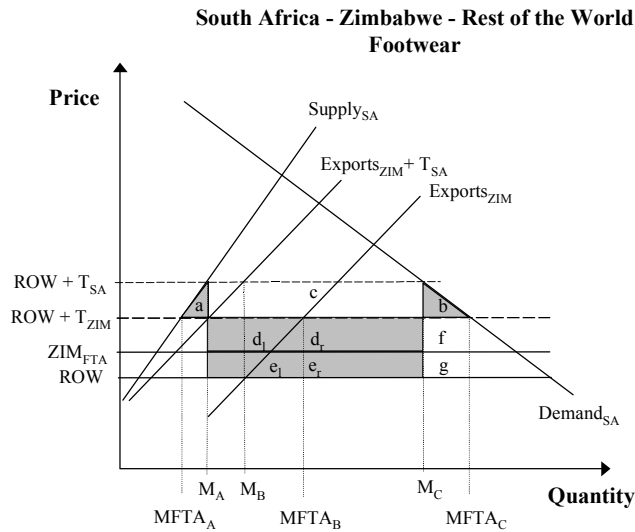


Figure 3. Free Trade Area

By abolishing internal tariffs, the export supply curve of Zimbabwean manufacturers shifts outward. At the same instance, the domestic price level for Footwear drops within the FTA to a level of $ROW + T_{ZIM}$, as Zimbabwe's tariff rate for imports from the ROW are substantially less than South Africa's. Again we can track down the two major effects on trade:

- (i) *trade creation* due to the fall in Footwear prices for the FTA. In Fig. 3, this effect is depicted by the areas (a + b).
- (ii) *trade diversion*, as South Africa imports substantially more shoes from Zimbabwe ($MFTA_B - MFTA_A$) \square ($M_B - M_A$) and (relatively) less from ROW manufacturers. Previous imports from ROW ($M_C - M_B$) are partly substituted by Zimbabwean ones. Assuming

that there are no rules of origin, the imports from ROW producers are actually imported via Zimbabwe.

The welfare effects for the different countries are the following:

- (i) *South Africa* – consumer surplus increases by the areas $(a + b + c)$ due to a drop in the domestic Footwear prices. Government revenue (e.g. tariff revenue) declines by the rectangles $(c + d + e)$. Therefore, the net effect for South Africa is determined by comparing the areas $(a + b)$ with $(d + e)$. So, South Africa will only end up with a positive overall welfare effect, if the inefficiencies of Zimbabwean manufacturers compared to the ROW ones are relatively small and the tariffs (T_{ZIM}) levied on Zimbabwean Footwear imports are minor.
- (ii) *Zimbabwe* – as export production rises substantially, Zimbabwe will gain additional producer surplus. Also, the government earns additional tariff revenues in amount of $(d_r + e_r + f + g)$.
- (iii) *Rest of the World* – export production will decline, most probably in absolute as well as relative terms, due to trade diversion. ROW ends up with a diminished producer surplus.

Compared to a Customs Union, a Free Trade Area is worse for the importing country – in our case South Africa, since in addition to trade diversion, an FTA also shifts tariff revenues from South Africa in favour of Zimbabwe. For both of our Preferential Trade Arrangements, the welfare loss for South Africa is the larger, the less efficient the Zimbabwean Footwear manufacturers are. In reality, the FTAs in

Southern Africa have *Rules of Origin* in place. Usually a set of criteria that distinguish between goods produced within the member states, which are entitled to duty-free or preferential treatment, and those that are produced outside the region. The most important being, that the „value added resulting from the process of producing the goods from imported materials should account for at least 35% of the ex-factory cost of the goods“ (COMESA 2001:3). If Rules of Origin are enforced, the domestic price of shoes in South Africa remains at $ROW + T_{SA}$, South African consumers do not increase their surplus, but the government will still lose a substantial amount of tariff revenues (Fig. 3).

Our first two models just looked at the *ceteris paribus static gains* of regional integration arrangements due to trade creation. But, as we mentioned in the first part, over the long-term the *dynamic gains* – based on increased competition, economies of scale and spillover effects – are very likely to be much more important. In the following paragraph, we will present a model that incorporates economies of scale, which are prevalent in manufacturing industries.

c. Economies of Scale and Regional Integration Arrangements

We construct an economies of scale model on a sectoral level by looking at two sectors, in which each different member country of our RIA has an advantage in production. At first, we will look at the *machinery* industry (Fig. 4). Based on the simplifying assumption that companies in South Africa as well as in Zimbabwe essentially face the same average costs at a given level of production, under autarky the latter is

determined in each country by its domestic demand for machinery. The demand curves in both countries as well as the average cost curve are downward sloping. By introducing declining average unit costs as output increases, we are graphically depicting economies of scale in the machinery industry. As Zimbabwe's domestic market size is only about 4,5% of South Africa's (GDP in US\$), the efficient production level for its machinery industry (E_{ZIM}) lies way to the left on the average cost curve. On the other hand, the South African economy provides for a much higher output at relatively low prices. Though, South African producers are still less efficient than foreign competitors (ROW). The substantial difference in market size determines the level of tariff protection necessary to allow for domestic production. In the case of Zimbabwe the government decided to levy a tariff that is not sufficiently high enough in making domestic production profitable. Zimbabwe imports machinery in the volume of M_{ZIM} . South Africa implemented a moderate tariff rate on imported machinery – but, still high enough to protect local producers.

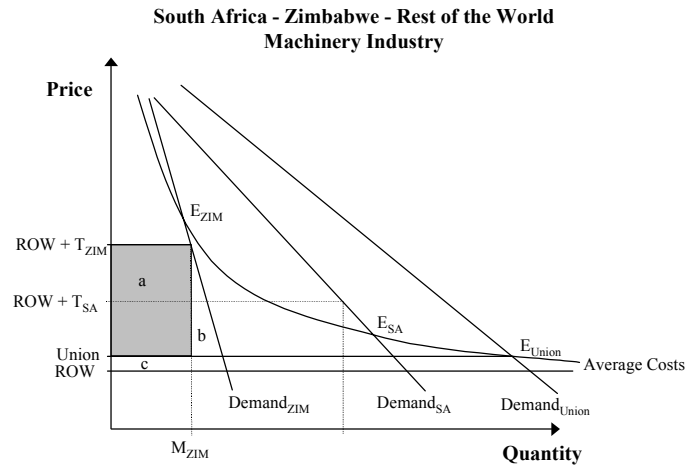


Figure 4. Economies of Scale in the Machinery Industry

What will be the effect of a Customs Union or a Free Trade Area in this case? Well, the increase in market size of a CU or FTA leads to declining average unit costs and the efficient output level of the RIA shifts to the right; i.e. production increases at E_{Union}. This is true, as long as the tariff rates – either a uniform external tariff (CU) or both individual tariffs (FTA) – exceed the difference of the Union price level and ROW. Then the industries within the RIA remain competitive versus machinery imports. The following are the welfare effects:

- (i) *South Africa* – producer profits rise due to an increase in „domestic“ market size and economies of scale. South African companies export more (and exclusively) to Zimbabwe. Government revenue increase as company profits rise (corporate tax revenue). Consumer surplus is raised as they enjoy lower prices for machinery. Overall, the South African economy unanimously profits from the RIA.

- (ii) *Zimbabwe* – instead of importing machinery from the rest of the world, the source of machinery imports shifts to South African producers. Besides this *trade diversion*, there is only little trade creation as the fall in machinery prices is only limited. Government revenues decline by the areas (a + c), while consumer surplus increases by (a + b). Therefore, the net effect for Zimbabwe depends on the size of areas (b) versus (c). Only if the inefficiency of South African machinery suppliers is relatively small, will the welfare of Zimbabwe rise.
- (iii) *Rest of the World* – export production will decline due to trade diversion. ROW producers will hardly be hurt, as the Zimbabwean domestic market is so small in size.

In our second sectoral example, we take a look at the *textile* industry (Fig. 5). The manufacturing of textiles is labor intensive and relatively low-tech. Due to the degree of labour market regulation in South Africa, wage levels in the formal sectors are way above the ones in other SADC countries. Compared to South Africa, Zimbabwean labour costs are about a third or less. Therefore, textile manufacturers in both countries face different average costs at various levels of production; i.e. the average cost curve for South African producer is at all output levels above the one in Zimbabwe. Before the two countries decided on a Regional Integration Arrangement, the governments – each facing large unemployment levels – levy the individual tariff rates for textile imports so high, that it became profitable for domestic manufacturers to enter the market. Textile output is

determined in both countries by the intersection of domestic demand and average costs at E_{ZIM} and E_{SA} respectively.

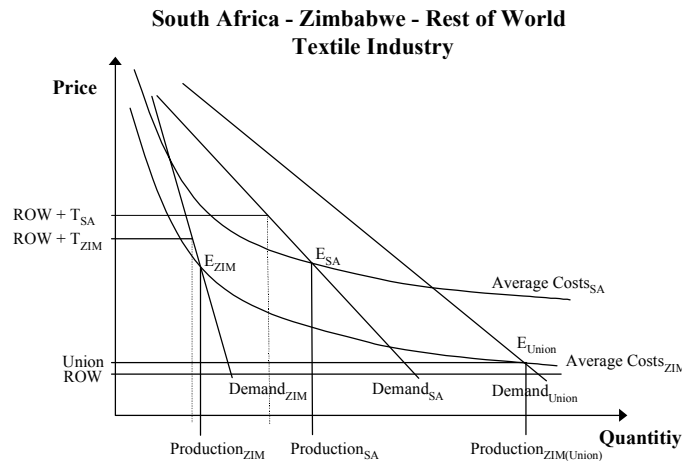


Figure 5. Economies of Scale in the Textile Industry

What happens, when South Africa and Zimbabwe agree upon a Customs Union or Free Trade Area? Again, the increase in market size leads to declining average unit costs on both cost curves and the efficient output level of the RIA shifts to the right. In this uniform domestic market South African manufacturers are not cost efficient anymore. They are forced out of business by their Zimbabwean competitors due to much higher labour costs. The South African textile producers might also shift their plants to Zimbabwe – essentially foreign direct investments – to make use of the low wage level. In both cases, we will see a *relocation of textile*

industry – from South Africa to Zimbabwe.¹¹ What are the welfare implications for the two countries?

- (i) *South Africa* – the relocation of the labour intensive textile industry to Zimbabwe leads to major frictions in the labour market. Textile workers become unemployed and unions as well as owners will lobby for import protection. Government loses corporate revenues. But, consumer surplus will surge as textile prices tumble. We end up with a major distribution problem due to a structural change in the manufacturing sector finding labour, textile company owners and (probably) government on one side and consumers on the other.
- (ii) *Zimbabwe* – due to its comparative cost advantage, the relocation of textile industries is unanimously welfare enhancing. Both, consumer and producer surplus rise and government revenues increase (corporate taxes).
- (iii) *Rest of the World* – no implications as there are no textile exports to the region before and after forming a RIA.

Taking both sectoral examples – machinery and textiles – into account, a country gains by forming a RIA, if the industries that are affected by trade liberalization relocate to its own shore. If the structural change is in favour of the partner country, then the home country is faced with the negative effects on labour and capital markets of this structural change. Though, in the long-run the enhanced allocation of resources and other dynamic gains should lead

¹¹ This only holds as long as tariff rates of both countries (FTA) or of the customs union are more than the difference of Union and ROW prices.

to a win-win situation for both trading partners. Both examples also clarified that the structural changes for the member countries differ from sector to sector. In textiles, Zimbabwe is on the winning side. The opposite was true for machinery.¹² Within the SADC context and South Africa's high labour costs, labour intensive industries relocate to other Southern African countries, while South Africa's comparative advantage lies in the more capital- as well as know-how-intensive manufacturing and service industries.

3. BENEFITS AND COSTS OF RIAs

Up to now we have seen how to graphically model the major effects of RIAs. Before we present the various regional integration agreements in Southern Africa, let us briefly discuss benefits and risks of RIA by looking at empirical examples. For the European Union the *static gains* of a free movement of goods, services, labour and capital – the single market of 1992 - have been estimated by several studies to range up to 5% of EU GDP (World Bank 2000:32). Turning to low-income countries, the potential gains through regional trade liberalization may be even larger: Due to the small size and relatively closed structure of many developing countries, the positive effects on growth through outward-orientation (see part 1) should be much more prominent. But, as cross-country studies have shown in the past, *South-South RIAs* were not able to lock in those potential benefits. For the

¹² The moment tariffs on machinery imports in Zimbabwe are set high enough to deter foreign competition (in Fig. 4), we would have seen a relocation of industry from Zimbabwe to South Africa. Zimbabwean companies had to give up production due to their unfavourable cost competitiveness on the basis of smaller economies of scale compared to their South African counterparts.

more recent Latin American MERCOSUR, simulations suggest GDP gains of 1.1% (Brazil) to 2.3% (Uruguay).¹³ Based on a computable general equilibrium model Lewis (2001:39) estimated that an FTA between South Africa and Southern Africa increases the real GDP of the region only by 0.33% and its employment by less than 1%.

What about the economic benefits of *North-South RIAs*? Simulating the future enlargement of the EU by ten low-income East-European countries, Kohler (2000:128) suggests that the growth effects due to the liberalization of the goods market for the old EU are very limited – less than 0.1% of EU GDP.¹⁴ The reason being that these countries already enjoy almost free access to the EU market through the „Europe Agreements“ of 1991-1995, and that they increase EU's GDP by only 5%. Past as well as the future enlargements of the EU are much more than just lifting trade restrictions. It is a *deep integration* that will liberalize the goods, services, labour and capital markets over a limited period of time. To become an EU member, the countries have to be democratic, politically stable and economically competitive, and they got to implement the „acquis communautaire“ - about 80.000 pages of legal requirements. At the same time, the new member gets access to substantial financial transfers from the EU budget through the common agricultural policy and structural funds. Therefore, most of

¹³ The large Brazilian economy gaining less because it is already closer to reaping economies of scale (Flores 1997 in: World Bank 2000:33).

¹⁴ Austria, Germany and Finland will gain on a net basis – taking the transfers to the new member countries into account; while especially the Southern rim of the EU (Spain, Portugal, Greece) and Ireland will be negatively affected (Kohler 2000:137).

the benefits will come from long-term dynamic gains for both the old as well as the new EU members. The relevance of these dynamic forces is reflected by the rapid convergence of formerly low-income countries to the levels of the core countries of France, Germany, Italy and the United Kingdom. Between 1985 and 1998 per capita income levels have moved up for Ireland from 61% to 91%, for Portugal from 27% to 38% and Spain from 49% to 67% - in percentage of the core countries.¹⁵

In 2000 a Free Trade Agreement similar to the EU-South African one came into force between the EU and Mexico. It is the first between a Latin American country and the EU, and it is also a „trade“ agreement that includes services, investment, public procurement, intellectual property, and competition. In that sense it aims at a deeper integration than the EU-South Africa FTA. Though, Mexico's trade dependence on the EU is substantially less than South Africa's.¹⁶ Busse et al. (2000:24) estimated that the trade effects - *static gains* - were only 5% of total trade for Mexico and 29% for the EU due to higher Mexican import duties. If one concentrates on the growth effects of trade creation, these amount to 0,03% and 0,02% of GDP for Mexico and the EU respectively. Again, these static gains are of limited nature, but over the long-run especially Mexico will improve

¹⁵ Greece is the only low-income EU member that did not catch up, due to the slow pace in reforming the economy; its per capita income level is still at 50%.

¹⁶ The EU's profile in Mexico's foreign trade declined dramatically during the last decade from 15.5% (1990) to 6.4% (1998), largely reflecting the fact that NAFTA came into force (Busse et al. 2000: 8). South Africa's trade share with the EU in 1999 stood at 34,6% (SARS 2000).

its position as a location for EU foreign direct investments to break into the North-American market reaping dynamic benefits.

Comparing the EU FTAs with South Africa and Mexico respectively, trade creation has a more pronounced impact on the South African economy than on Mexico's. South African real GDP increases by 0.44%, whereas there are only negligible changes for the EU. „These lopsided gains reflect differences in both trade dependence and bilateral trade structure.“ (Lewis 2001:38). The substantially higher impact on South African GDP is due to the fact that its trade share with the EU is more than 5 times as large as Mexico's.

For NAFTA, which is only fully implemented by 2008, various simulations and empirical studies were undertaken before and since it came into force in 1994. Generally, the impact of NAFTA on the U.S. have been relatively small, and for Mexico quite substantial, while changes in trade flows did not give much support to view that NAFTA is seriously trade diverting (Krueger 1999:3). Estimates on growth effects vary from 6-12% of GDP for Mexico to 0,25-1% for the U.S.. Again the different gains are due to differences in trade dependence and tariff structure (Burfisher et al. 2001:126).

Up to this point we have looked at the empirical assessments of the benefits of a RIA, but there are also *risks or costs* attached to the formation of RIAs.

- (i) *Trade diversion* within an FTA might pose a problem, but the empirical evidence is quite contradictory and

in most estimates trade diversion was of limited nature.

- (ii) *Loss in tariff revenues* are especially of relevance for RIAs including developing countries. Often LDCs have a generally narrow tax base and incompetent tax administration, so that import duties are an important source of government revenue. The last column of Table 1 presents the revenue implications of a SADC FTA.

Country	SADC imports / total imports	Import duty from SADC / total import duties	Import duties / total revenues	change in total revenues due to FTA
Malawi	47.4	37.1	16.3	-7.0
Mauritius	17.2	16.9	28.7	-5.4
South Africa	2.5	0.7	3.6	-0.1
Tanzania	7.7	8.6	26.1	-2.3
Zambia	48.0	48.0	11.7	-6.2
Zimbabwe	48.7	55.5	17.8	-11.0

Table 1. Trade, Duty Flows, and Revenue Implications of an SADC FTA

Source: Tsikata (1999) in Lewis (2001:29-30)

The fiscal implications of a full FTA are severe for Zimbabwe, Zambia, Malawi and Mauritius.¹⁷ This points to the need to ensure that alternative tax systems are in place before removing these substantial sources of tax revenue.

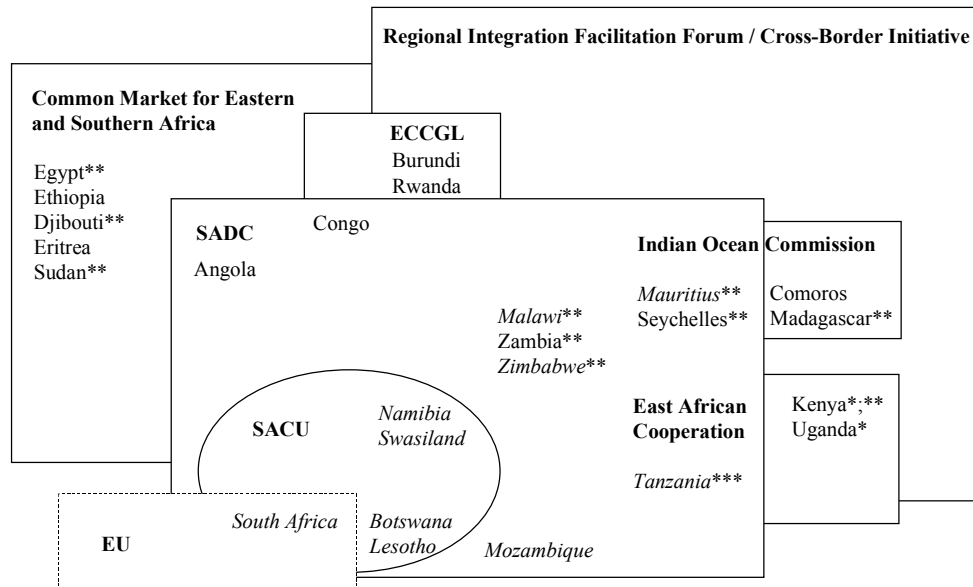
¹⁷ The same is true for the poorer SACU member countries Lesotho, Namibia and Swaziland – between 30-50% of their government revenues are customs revenues shared according to an agreed formula.

- (iii) *Relocation of industries* will differ sector- as well as countrywise. They will be based on a country's comparative advantage, economies of scale effects due to different market sizes and *agglomeration advantages*. The advantage of existing industrial clusters is due to knowledge spillovers, labor market pooling and the proximity to business partners (Porter 1998:81). As McCarthy (1999:390) mentions, it is quite reasonable to assume that for most industries the marginal cost of production is lower in South African metropolitan areas than in the lesser developed SADC economies. In the short- run, governments will face distribution problems as well as social conflicts due to these structural changes. But within a South-South RIA the relocation of industries can even lead to a long-term divergence of per capital income levels. The break-up of the East African Community in 1977 poses as an example for such a divergence: Kenya's manufacturing industry had a comparative advantage relative to Uganda's. Therefore, Uganda lost industrial production sites to Kenya, and at same instance Uganda was forced to import more expensive manufactured goods from Kenya as high external tariffs didn't allow Ugandans to consume cheaper world imports (Venables 1999:4-5).

4. RIAs IN SOUTHERN AFRICA

In Southern Africa we find a large number of overlapping RIAs (Fig. 6). In addition to these RIAs, several bilateral trading arrangements exist as of 1999 within the SADC context: three between South Africa and Zimbabwe

(confined to clothing and textiles), Malawi as well as Mozambique. Also, three FTA exist between Zimbabwe and Botswana, Malawi as well as Namibia. The other major trade arrangements, which are not listed in Fig. 6, are the Lomé/Cotonou Preferential Trade Agreement between the EU and Southern African LDCs and the US African Growth Opportunity Act.¹⁸



* Application for SADC; **member of COMESA FTA; *** no acting member of COMESA; member of SADC FTA.

Figure 6. Regional Integration Arrangements in Southern Africa
 ECCGL: Economic Community of the Countries of the Great Lakes; SACU: Southern African Customs Union.

¹⁸ The AGOA was promulgated by the US government in October 2000. The Act extends Generalised System of Preferences status for qualifying African Countries (e.g. SADC except Angola, Congo and Zimbabwe) to 2008 and expands the existing list of 4.650 GSP products by 1.837.

Five of the eight RIAs mentioned are typical *South-South RIAs*: COMESA (founded in 1994), ECCGL (1976), Indian Ocean Commission (1982), East African Cooperation (revival of the East African Community in 1993) and the Regional Integration Facilitation Forum or former Cross Border Initiative (1992). The EU-South Africa FTA is again a typical *North-South RIA*.¹⁹ But, how would you classify SADC (1980) or SACU (1910)? Well, these are Regional Integration Agreements between an emerging market economy with a strong manufacturing base as well as a first-world financial sector and government institutions, and, on the other hand, mainly small and low-income countries. Therefore, we classify them as *quasi North-South RIAs*.

Before we start assessing the advantages or problems of a large number of overlapping RIAs, let us note that the situation in Southern Africa is no exception to the rule. In other parts of the world - namely Europe - we find similar clusters of RIAs.²⁰ What *advantages* of overlapping RIAs can one think of?

- (i) A country with memberships in several RIAs might be an interesting production location for foreign investors. It should attract foreign direct investments, if the other members of the RIA impose more protectionist measures (tariffs or NTBs) than the

¹⁹ Like in the EU-Mexico FTA, there is an asymmetric pace of trade liberalization. The EU opens its market faster to South African exporters, than vice versa. But, there are also exceptions on both sides for sensitive sectors like textiles, clothing, shoes, carparts or agricultural sub-sectors.

²⁰ e.g. EU, Europe Agreements with East-European Countries, PTA with Turkey, with Mediterranean countries, EFTA and even within the EU: European Monetary Union, Treaty of Schengen.

- country in question. The moment Rules of Origin are enforced, this advantage diminishes.
- (ii) Based on the history of European integration, usually founding members enjoy more economic advantages than late joiners. Their political cloud is higher, as they determine the conditions under which new member countries join the club.²¹ In this respect SADC is an exception, as the late joiner – South Africa in 1994 – is the regional powerhouse in Southern Africa.

While these economic advantages of overlapping RIAs are difficult to measure, the *problems* that are involved with a messy cluster of Preferential Trade Agreements can easily be detected:

- (i) Countries with memberships in several RIAs might be interesting for foreign investors, but the latter are often also deterred by the *complexity* of trade regulations that arises due to different RIAs – especially, when there many exceptions to the rule like NTBs or sector specific ones. Also, the complexity due to various RIAs often reduces the commitment and pace by which the government agencies implement the trade arrangements. This is especially the case for low-income countries in Southern Africa with limited administrative manpower and know-how.

²¹ e.g. the regional transfer payments that the Mediterranean countries Greece, Portugal and Spain, who joined the EU in the 1980ies, recieved, are much larger than what the Easteuropeans can expect.

- (ii) For governments trying to implement the regulations of various RIAs one finds usually a *declining commitment for trade liberalization* on a multilateral base. Especially, when the fiscal implications of opening the domestic market (loss of tariff revenue) are severe.
- (iii) Some Countries face *conflicting obligations and inconsistencies*: „as members of a future Customs Union (COMESA) they will not be able to offer preferences to non-members with whom they are partners in another free trade arrangement (SADC)“ (IMF 2001:82).
- (iv) *Political conflicts*, within or between member countries, delay further integration (or its implementation). Unfortunately, these are quite common in Southern Africa; e.g. the civil wars in Angola, Congo, Burundi and the „social“ unrest in Zimbabwe.

5. OPTIONS FOR SOUTH AFRICA

In facing the above mentioned problems of overlapping Regional Integration Arrangements in the Southern African context as well as the fact that intra-regional trade is comparatively low with just 12% of total trade (Yeats 1998),²² what are the first-best or second-best trade policies from a South African perspective?

²² Overall, Africa's share of world trade dropped from 2.3% (1970) to 0.8% (1999). African countries tend to trade less both with the ROW and with themselves due to poor infrastructure, difficult access to trade finance, and restrictive trade policies (Limao/Venables 1999:24; IMF 2001:80). Intra-industry trade usually associated with regional integration hardly exists in Sub-Saharan Africa (Yeats 1998:21).

In general, a free trade area or a customs union will increase economic growth potentials. But these benefits are not evenly distributed among and within the different member countries: e.g. in some cases consumer welfare rises, while the custom revenues deteriorate. By taking *economies of scale* into account, we showed that an FTA between South Africa and Zimbabwe will lead to a substantial relocation of industries in both directions – with all its strain on the labor market. But, the general *agglomeration effects* should stress the advantage of existing South African industrial clusters in attracting service and manufacturing industries. Mainly, only very labour intensive industries might relocation to other Southern African countries. The net effect of relocation of industries should remain positive for South Africa.

Due to low trade creation, it seems that *South-South RIAs* (COMESA, RIFF-CBI, EAC, IOC, ECCGL) have significant more potential drawbacks than *North-South RIAs* (EU-South Africa, Cotonou, AGOA) or *quasi North-South RIAs* like SADC and SACU. The overlapping trade agreements also deter foreign direct investment due to the little transparency provided, and they are slowing down the pace of liberalization and harmonization on a more general, multilateral basis. Also, Regional Integration Arrangements are supposedly agreements between natural trading partners within a region. Considering the missing proximity and low intensity of trade as well as of other economic links, several of the COMESA and SADC member countries do not classify as natural trading partners; e.g. Congo and South

Africa, Egypt and Zimbabwe.²³ So, the success of forming RIAs with a diversified group of countries should be limited in any case.

The European integration has shown that the depth of an integration process determines its long-term success. There are a lot more dynamic gains involved, when integration extends far beyond the goods market and includes services, capital and labor. In addition, the institutional capacity should be strengthened by harmonizing the legal systems. And it might include the construction of shared executive judicial and legislative institutions. The prerequisite for locking in major dynamic benefits are political and macroeconomic stability as well as good governance. Unfortunately, only a limited number of Southern African countries actually fulfill these criteria.

Taking the diversity of the member countries of COMESA and SADC into account as well as the missing prerequisites for a deeper integration, *different speeds of liberalization and harmonization* within a subset of countries versus all members is a promising route to take for South Africa. Again, the EU precedes in this respect; e.g. Schengen Treaty (7 countries) - European Monetary Union (12 countries) - EU (15 countries).

As the European Union is economically much more important for South Africa – trade share with the EU: 35% - than the rest of Southern Africa (5% share in 1999), and as the increase in market size by the rest of SADC – i.e. South

²³ This is especially true for COMESA (IMF 2001:79).

Africa's *hinterland* – is relatively limited (40% South Africa's GDP), the welfare gains through increased market size and trade creation are a low compared to an FTA with the EU.²⁴ Therefore, South Africa should put much more emphasis on trade liberalization and a more pronounced legal harmonization like investment rules, taxes or standards with the EU or even the US (trade share of 10%) than with its regional hinterland. It should also stay clear of joining COMESA.

Despite South Africa's strides taken in liberalizing the economy since 1994, its tariff regime continues to be very complex, a number of key sectors remain highly protected, and lately, it has become a major user of antidumping actions (Subramanian 2000:58). So, there is still enough room for substantial steps towards trade liberalization to enhance productivity and economic growth perspectives. The first-best policy for South Africa is still a multilateral liberalization followed by a simultaneous one with the EU, US and its neighbouring countries.

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²⁴ This is even much more pronounced for the low-income countries of Southern Africa and a RIA between them and the EU versus one just with South Africa. A trilateral FTA between them, South Africa and the EU would increase their real GDP by 4.1% - compared to 0,33%, when they form an FTA with South Africa alone (Lewis 2001: 39).

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