

**REGIONAL ECONOMIC INTEGRATION AND  
ECONOMIC DEVELOPMENT IN  
SOUTHERN AFRICA**

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# **REGIONAL ECONOMIC INTEGRATION AND ECONOMIC DEVELOPMENT IN SOUTHERN AFRICA**

by

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**ABBREVIATIONS AND ACRONYMS**

ACP	Africa, Caribbean and Pacific Countries
AGOA	Africa Growth and Opportunities Act
ASEAN	Association of South East Asian Nations
AU	African Union
BCEAO	Central Bank of West African States
BNLS	Botswana, Namibia, Lesotho and Swaziland
CET	Common External Tariff
COMESA	Common Market for Eastern and Southern Africa
DBSA	Development Bank of Southern Africa
DDA	Doha Development Agenda
DRC	Democratic Republic of Congo
EAC	East African Community
EEC	European Economic Community
EFTA	European Free Trade Area
EPA	Economic Partnership Agreement
ERM	Exchange Rate Mechanism
ESA	Eastern and Southern Africa

EU	European Union
FDI	Foreign Direct Investment
FOPRISA	Formative Process Research on Integration in Southern Africa
FTA	Free Trade Agreement
GDP	Gross Domestic Product
ICT	Information and Communication Technology
IDC	Industrial Development Cooperation
IMF	International Monetary Fund
LAFTA	Latin America Free Trade Association
MERCUSOR	Southern Common Market
MFN	Most Favoured Nation
NAFTA	North America Free Trade Agreement
NTBs	Non-Tariff Barriers
REC	Regional Economic Community
RIA	Regional Integration Agreement
RISDP	Regional Indicative Strategic Development Plan
RoO	Rules of Origin
RSA	Republic of South Africa
SACU	Southern African Custom Union

SADC	Southern African Development Community
TDCA	Trade and Development Cooperation Agreement
UNCTAD	United Nation Conference on Trade and Development
WAEMU	West Africa Economic and Monetary Union
WTO	World Trade Organization

## SUMMARY

*The impetus for regional integration draws its rationale from the standard international trade theory, which states that free trade is beneficial to all. Free trade among two or more countries or preferential trade will improve the welfare of the member countries as long as the arrangement leads to a net trade creation in the Vinerian sense. The history of regional economic integration in Southern Africa (SADC) reveals that it has not yet achieved the economic benefits that are attributable to developing regions, namely: higher levels of welfare exemplified by low poverty levels, economic development and industrialisation. Regional economic integration in Southern Africa is constrained by high tariff and non-tariff barriers, archaic infrastructures and multiple memberships among different regional economic communities. A SADC-wide customs union can be successful, provided that countries are allowed to join, when their economies have adjusted and the South African Customs Union (SACU) is used as a nucleus.*

## KEY TERMS

Regional integration arrangement (RIA), regional economic communities (RECs), South African Customs Union (SACU), Southern African Development Community (SADC), customs union, trade creation and diversion, variable geometry, economic development, macroeconomic convergence, welfare.



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## CHAPTER 1

### INTRODUCTION:

#### 1.1 Introduction

Regional integration agreements (RIAs) are entered into by two or more countries (not necessarily belonging to the same geographical region). In terms of these agreements, member countries agree to lower tariff and non-tariff barriers (between each other) so that transaction costs will be lowered in the hope that this will lead to a higher level of welfare and economic development (McCarthy, 2004).

The premise on which these agreements rests is that a home market is smaller than the combined markets in an RIA, and as such will not have an economic impact globally should the country act unilaterally. A combined market will result in the lowering of input costs as a result of the enlarged market – a term referred to as economies of scale<sup>1</sup> (Lawrence, 1995: 9; De Melo & Panagariya, 1993).

According to Limao and Venables (2001) regional economic communities<sup>2</sup> may help countries adopt policies, build institutions, and develop the infrastructure needed to expand trade in goods and services. Jansen and Vennes (2006:14) stress that RIAs can help increase the benefits accruing from participation in international trade and simultaneously reduce the associated costs. RIAs will help the participating countries liberalise trade policy relatively cheaply, reduce the risk of possible protectionist measures on the part of trading

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<sup>1</sup> Economies of scale refer to the reduction of input costs as a result of an increase in output because of market enlargement.

<sup>2</sup> Regional Economic Communities (RECs) and Regional Integration Agreement (RIA) will be used interchangeably in this document to mean the same thing.

partners, boost intra-regional trade, and overcome domestic political resistance to broader trade liberalisation.

## **1.2 The history of regional economic integration agreements**

According to Viner (1950:7), Meade (1955), Balassa (1961) and Machlup (1976) there is a considerable historical antecedent to RIAs and RIAs are a precursor to multilateralism. Certain RIAs may be traced back to the era of nation-building in Europe, for example, the Zollverein of nineteenth century Germany (formed in 1830) and the Cobden Treaty of 1860 between France and the United Kingdom. During the post-war period (World War II which ended in 1945) developments in regional economic agreement were led by the European Union (EU, originally the European Economic Community founded in 1957 by France and Germany). During the 60s and 70s, there was a plethora of inward-looking (and largely unsuccessful) RIAs between developing countries (Cooper & Massel, 1965; Robson, 1987; Krishna, 1995). The mid-1980s and 1990s ushered in a period that witnessed a dramatic increase in regional integration activity between developing countries. These regional integration activities, unlike that of earlier years were outward-looking, in that the promotion of exports was the overriding objective.

## **1.3 The regional integration agreements notified to the World Trade Organization**

According to the World Bank (2005a) there are more than 300 RIAs notified to the General Agreement on Trade and Tariffs (GATT) which was absorbed into the World Trade Organization (WTO) in 1995. Almost all countries are members of at least one RIA, and more than one third of world trade takes place within the ambit of these agreements. The new developments include the expansion and deepening of the EU (from common market into economic union); the

implementation of new and more open RIAs between developing countries (South-South integration) such as the Association of South East Asian Nations (ASEAN) comprising member countries whose geographical location is South East Asia; and the advent of RIAs in terms of which both developed and developing countries are equal partners, for example, the North American Free Trade Area (NAFTA) which, in 1994, extended the Canadian-USA free trade agreement to Mexico (Bhagwati & Krueger, 1995; Coe & Hofmaister, 1998).

RIAs vary in several respects such as income levels (NAFTA in which Canada and the US are high-income countries whereas Mexico is a middle-income country), in openness to trade, and in the share of trade that takes place within the RIA, for example, 60 percent for the 27-member EU, but just 10 percent for the eight members of the West African Economic and Monetary Union (WAEMU). RIAs also vary in structure – from the loose agreements of the African Cross-Border Initiative (in Southern Africa in the eighties) and the Asia Pacific Economic Cooperation (APEC) forum which aim at facilitating trade, through to the deep integration of the EU which involves the establishment of shared executive, judicial and legislative institutions (Salvatore, 1990; Piazzolo, 2002; Aryeetey, 2003). According to Bhagwati (1993) the new wave of RIAs differ from the regionalism of the 1960s in terms of orientation, but the fundamental economic rationale still derives from the Vinerian analysis of trade creation and diversion, and economies of scale, as exemplified in the motivations of early European integration (McMillan & McCann, 1981).

Insofar as they lead to broad-based trade liberalisation in individual countries, regional integration agreements contribute to multilateral trade liberalisation and complement the multilateral trading system as represented by the World Trade Organisation (WTO). For example,

many RECs (such as SACU<sup>3</sup>) contain clauses that indicate that such arrangements are a precursor to global integration (Southern Africa Customs Union Treaty, 2002). However, Viner (1950) and Meade (1955) have shown that RIAs both create and divert trade between member and non-member countries. Regional economic integration may, however, give rise to vested interests in partial trade liberalisation, and this in turn could hinder broader trade liberalisation and render it politically more difficult to implement. The discriminatory nature of the RIA could also weaken the multilateral trading system, which is based on the principle of non-discrimination for all members based on the Most Favoured Nation principle<sup>4</sup> (Irwin, 1993; Africa Integration Review, 2007).

#### **1.4 The outline of the dissertation**

The focus of the dissertation is to analyse the impact of regional economic integration in Southern Africa on economic development in areas such as infrastructure development, poverty eradication and to ascertain whether it has led to an improvement in the welfare of the people of Southern Africa. Regional economic communities in Southern Africa are beset by a myriad of problems. For example, fourteen Southern African countries are members of four regional economic communities, namely, the Common Market for Eastern and Southern Africa (COMESA), the East Africa Economic Community (EAC), the Southern African Customs Union (SACU) and the Southern Africa Development Community (SADC). The EAC and SACU are customs unions whilst it is planned that both COMESA and SADC will evolve into

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<sup>3</sup> SACU refers to Southern African Custom Union which comprises Botswana, Lesotho, Namibia, South Africa and Swaziland. The SACU clause confirming the region to multilateralism is in the SACU Treaty signed in 2002.

<sup>4</sup> The Most Favoured Nation principle refers to the just treatment of trading partners. For example, if country A gives preference to goods from B, it must then give preference to all nations trading in similar goods.

customs unions by the end 2008 and 2010 respectively (SADC Today, 2006). This will be discussed in detail in Chapters 4 and 5.

According to the General Agreement on Trade and Tariffs (1993) Chapter XXIV,<sup>5</sup> a country may not belong to more than two customs unions and therefore the member states of the three RECs in Southern Africa will have to choose to which customs union they wish to belong. SACU is acknowledged as the oldest and most successful of the three customs unions. As preparations for launching the SADC customs union take shape there is the belief by South African policy makers that SACU should form the nucleus of the SADC customs union.

South Africa, which is regarded as the guardian of SACU with its quarterly payment of SACU collected revenue to the other four member states, upholds this view, but cautions that such an arrangement should be devoid of the revenue sharing mechanism (RSM), which is currently the main feature of SACU. With the RSM, customs duties derived from extra-SACU imports are pooled in the Common Revenue Pool and shared by member states in proportion to their share of the intra-SACU trade (McCarthy, 2004).

For SACU to serve as a model for the new SADC customs union, it must be reformed from its current structure, which reflects a union that exists merely to collect and distribute revenue emanating from customs duties. Its reformation need to produce a structure that enhance economic development in the region and increase the gains associated

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<sup>5</sup> According to GATT Chapter XXIV, a country may not belong to more than one customs union unless the two unions have a timetable which allows for the phasing out of tariff lines simultaneously. It is however difficult to find such a precedent (of a country being a member of two customs unions).

with trade. For South Africa, it makes sense to lobby for SACU as a springboard so that the long tradition and experiences of SACU are not lost. A certain degree of lobbying for this position might be required. Strategically, the expansion of SACU into a new SADC customs union will provide South Africa with an opportunity to influence and guide the process. In this dissertation, it will be argued that regional integration in South Africa will be successful on condition that the SACU customs union model is adopted. The condition of adopting a SACU customs union model will hinge on the reform process that is currently taking place. The aim of the reforms is to transform SACU from an institution whose rationale for existence is revenue collection and distribution to a fully fledged customs union with common industrial policies, agreement on services, competition policies and so forth (Southern Africa Customs Union Treaty, 2002; McCarthy, 2004).

SACU will be contrasted with other successful customs unions, in particular, with the EU, in order to strengthen the argument that it is the correct model on which to build the new SADC customs union. The choice of the SACU model over the EU model is based on the fact that five SADC members are already members of SACU and this will facilitate the transition to the new SADC customs union configuration.

The dissertation is divided into six chapters. Chapter 2 outlines the theories of regional economic integration, in particular the customs union. In Southern Africa, SACU and EAC are already customs unions whilst SADC and COMESA are currently in negotiation that will lead to the establishment of customs unions. The customs union theory will be discussed in terms of traditional theories such as trade creation and trade diversion, in terms of economics of scale, polarisation and the terms of trade. The attainment of the above (minus trade diversion) will lead to the economic welfare of the citizenry and economic development within a customs territory. The theory will be traced from its evolution, dating back to the 1950s with Jacob Viner's seminal

analysis of customs union theory in terms of which the emphasis was on the production effects in a perfect market, to the current custom union analysis which, in addition to the production effects, has added the consumption effect in an imperfect market. The customs union theory under imperfect competition exemplifies the real-world phenomenon in customs unions of both developed and developing regions.

Chapter 3 contains a discussion of the benefits and costs of regional economic integration based on the experience of developing regions. Here one refers to both static gains of regional economic integration such as economies of scale, investments and so forth and the dynamic gains such increased bargaining power during trade negotiations and sharing of values within the community. Chapter 4 contrasts the experiences of regional economic integration in developing regions, in particular Africa, South East Asia and Latin America. Regional economic integration in EU, NAFTA and SACU case studies will be discussed in detail. RECs in Africa will be analysed to ascertain whether the current regional economic integration has led to the attainment of economic welfare and economic development as per the theory of regional economic integration/customs union. Suggestions will be made, which, if heeded by RECs in Africa, could lead to the arrest of the current state of under-development.

In Chapter 5, the focus will be on regional economic integration in Southern Africa with particular attention being paid to developments in COMESA, SACU and SADC. In light of the progress (through linear integration) made by SADC and COMESA towards graduating into customs unions, an argument will be advanced for the adoption of the SACU model (as opposed to the European Union model) for the future SADC customs union, since it will be proved that this model is both workable (for a developing region context) and will be beneficial for



Southern African economies. In Chapter 6 the discussions will be concluded and policy recommendations suggested.

## CHAPTER 2:

# TRADITIONAL THEORIES ON REGIONAL ECONOMIC INTEGRATION

## 2.1 Introduction

According to Viner (1950), Inotai (1986), Robson (1987) and Grossman (1995) the rationale behind the formation of regional integration agreements (RIAs<sup>6</sup>) is that both the consumers and producers will benefit from such a union. The consumers have the choice of goods at lower prices which will have been brought about by economies of scale. In the absence of regional integration agreement, tariffs are imposed on imports and this means that the consumers are forced to consume at higher prices, above the prevailing world price. Within regional economic communities, the removal of tariffs and non-tariff barriers (NTBs) will enhance consumer welfare. The producers, on the other hand, will benefit through intra-industry trade in terms of which input costs of their production will become cheaper.

With the proliferation of RIAs the question arises as to whether such arrangements benefit world trade, contribute to economic development, enhance the welfare of regions (countries) and increase overall global welfare? The answer depends on the difference between the trade creation and the trade diversion effects of regional economic integration. RIAs have been the subject of considerable economic analysis, beginning with the seminal contributions to the subject of customs unions by Viner (1950) and Meade (1955) who studied the economic costs and benefits of the customs union to its members and

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<sup>6</sup> In the dissertation any reference to regional integration arrangement (RIA) and regional economic communities (RECs) will refer to the customs union.

to the rest of the world (RoW). In this chapter the traditional theories of regional economic integration will be discussed.

## **2.2 Compatibility of RIAs with the World Trade Organization guidelines**

RIAs are discriminatory in nature and it is member countries only that benefit from such an arrangement. The question therefore arises as to whether RIAs are not an impediment to multilateral trade liberalisation as espoused by the World Trade Organization<sup>7</sup> and whether they violate the principle of most favoured nation (MFN) which stipulates that if a country gives trade preference to country A, then that country must extend the same preference to country C, D and so forth. Within RIAs, tariff and NTBs or technical barriers are reduced or removed only with intra-regional trade, thus implying that the relative prices of substitute goods (from non-member countries) will rise. Amid the strong forces forging closer economic ties among countries today regionalism has emerged as a force with the potential to rival multilateralism with, as yet, uncertain implications for the world trading system and the process of globalisation itself. RIAs are inconsistent with Article I (MFN) of the GATT which requires that nations treat all trading partners as they do their most-favoured trading partners. RIAs have constituted legitimate exceptions to MFN through Article XXIV of GATT, which permits the formation of RIAs if they meet the following conditions (General Agreement on Trade and Tariffs, 1993):

- a. When the members of the RIA gradually remove barriers on all intra-trade (not sectoral arrangements).

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<sup>7</sup> The World Trade Organisation (WTO) is an intergovernmental organisation which regulates global trade. Through trade rounds representatives of countries negotiate the lowering of tariffs and other impediments to global trade.

b. Agreed common external tariffs (in the case of custom unions) set by RIA members on non-member trade are not higher or more restrictive than those prior to the formation of the customs union. The common external tariff (CET) charged by members of the custom union should be at least the average (if not lower) of the tariffs of the member states before integration.

According to Qureshi (1996) and Krugman (1979; 1986) the integration of regional economies is seen as a first step in creating a larger regional market for trade and investment. This stimulates greater efficiency, productivity gains and competitiveness, not just by lowering border barriers, but by reducing other costs and risks of trade and investment (Mistry, 1996; Abdoulai, 2005). However, regional integration should not be seen as universal remedy for the problems associated with the economic development of member countries. In fact it has often been argued that the proliferation of RIAs hampers progress towards global integration and that costs and benefits are not shared equally, especially where there is asymmetry in economic development before integration. RIA is however seen as a development tool if it encourages a shift towards greater market openness and is geared towards global integration. A strong theoretical foundation to the admissibility of RIAs has been analysed by, among others, Viner (1950), Meade (1955), Lipsey (1957) and Vanek (1965), who have all indicated that, as long as RIAs do not lead to the diversion of trade, they are permissible since they could not pose a stumbling block to the attainment of global free trade (as espoused by the WTO).

### **2.3 Forms and examples of regional integration agreements**

There are various types of regional integration agreements. The first step towards any regional integration is the removal of tariffs and non-tariff barriers among member states. The tariffs are removed gradually within a specific period of time, for example, after the signing of the

Southern Africa Development Community Free Trade Area (FTA) protocol in 2000, SADC member states agreed to reduce their tariff lines to zero on all trade by 2012 in order for the region to qualify as a complete FTA. According to Balassa (1976) and Salvatore (1990) there are four classic types of regional arrangements – a free trade area, customs union, common market and an economic union.

### **2.3.1 Free trade area (FTA)**

According to Bhagwati and Panagariya (1996), Krueger (1997) and Grossman (1995), member countries belonging to an FTA agree to remove tariffs (and non-tariff barriers) gradually amongst each other, but maintain individual trade barriers with countries outside the FTA. Examples include the North American Free Trade Area (NAFTA) between the USA, Canada and Mexico, and the European Free Trade Association (EFTA) comprising Switzerland, Norway, Iceland and Liechtenstein.

### **2.3.2 Customs union**

In addition to jointly determining the tariff level among the members (as in an FTA) the member countries of a customs union agree to the unification of custom or trade policies towards non-members. They determine a common external tariff (CET) which is applied to trade with countries outside the customs union. Since there is a loss of sovereignty in terms of the setting up of a tariff level for customs union member countries, a mechanism may be put in place to compensate for the revenue loss that result from the removal of custom duties among member countries. Member countries are represented as a single unit in trade negotiations at the international trade rounds or conferences. SACU is an example of a customs union (Viner, 1950; McCarthy, 1994; Krueger, 1997; 2004).

The main features of a customs union include the following:

- A common set of import duty rates applied on goods from non-member countries (common external tariff (CET)).
- Duty-free and quota-free movement of tradable goods among the constituent customs territories.
- Common safety measures, such as sanitary requirements and food standards, for regulating the importation of goods from third parties.
- A common set of customs rules and procedures including documentation.
- A common coding and description of tradable goods (common tariff nomenclature (CTN)).
- A common valuation method for tradable goods for tax (duty) purposes (common valuation system).
- A structure for the collective administration of the customs union.
- A common trade policy that guides the trading relationships with non-member countries/trading blocs outside the customs union, that is, guidelines for entering into preferential trading arrangements with third parties.

### **2.3.3 Common market**

The common market is a customs union characterised by the free movement, without restriction, between the member countries of factors of production such as labour and capital. Countries agree to remove the internal barriers and jointly establish migration policies such as a common passport. The Southern Common Market (MERCOSUR) is an example of a common market in South America, comprising Argentina, Brazil, Paraguay and Uruguay (Piazolo, 2002: 1198).

### **2.3.4 Economic union**

According to Baldwin (1994) and Salvatore (1990) an economic union is a regional economic agreement in terms of which the level of integration is deeper than that of an FTA, customs union or common market. The member states adopt common economic policies, for example, the Common Agricultural Policy (CAP) of the European Union which regulates production in agriculture. The member states may have a fixed exchange rate regime, such as the exchange rate mechanism (ERM) of the European Monetary Union. In order to improve the management of currency volatility and reduce distortions to trade the member states also adopt a common currency, which involves a common monetary policy and the harmonisation of macroeconomic policies. The ultimate act of integration is likely to be some form of political integration in terms of which the national sovereignty is replaced by some form of supranational political authority. For example, the EU represents an economic union which has evolved gradually from the sectoral integration endorsed by the Treaty of Rome in 1957 (Baldwin, 1995; European Commission Report, 2005).

## **2.4 The evolution of customs union theory**

The best known customs unions have included the Zollverein between Germanic states in the nineteenth century, the Cobden Treaty between France and the United Kingdom, and the EEC, now known as the EU. Belgium, the Netherlands and Luxembourg established Benelux in the 1940s, while Belgium, France, Italy, Luxembourg, the Netherlands and West Germany set up the EU. Customs union theory builds on relatively strict assumptions such as perfect competition in commodity and factor markets. It has both positive and negative welfare effects, as compared to a situation in which every member state practises protectionism (Machlup, 1976).

According to Viner (1950) the establishment of a custom union could have ambiguous welfare effects. It is all depended on the issue of trade creation versus trade diversion. Trade creation would be new trade created by the supply of goods from a lower cost source than before. A member country would now import from the other member countries (within the union) goods that it formerly did not import at all because the price of the protected domestic product was lower than the price of the import from any foreign source plus the duty. Therefore, there would be a gain in welfare for that country. Trade diversion would be a situation in which a member country would buy from a more expensive partner instead of buying from a country with low production costs outside the customs union. In this case, there would be a loss of welfare for that country. It would not only increase its cost but also lose the tariff it would charge the third country outside the custom union.

Viner (1950) thus stressed the discriminatory aspects of regional trade liberalisation. The essence of what Viner (1950) said is that the welfare costs derived from trade diversion are borne by the consumers of the member countries, not by the exporters of third countries. Viner's (1950) customs union theory depended on the assumption that the production costs of future partner countries were supposed to be constant, whatever the amount produced. Therefore, the rent or excess profit element on the side of the producer did not feature in the analysis. Modern theory on customs union as espoused by Bhagwati (1977), Venables (1990), Baldwin (1994) assert that if costs are variable, a much more likely occurrence, then any discriminatory trade liberalisation will contain simultaneously elements of both trade creation and diversion.

Viner's analysis focused on resource allocation changes and on production efficiency when a customs union is formed. Viner's analysis did not cover the reaction of consumer demand within a union when the



prices of traded goods decreases/increases. Economic theory tells us that any price reduction will have a positive impact on welfare, known as the consumer's surplus whilst an increase in price will reduce the consumer surplus.

Lipsey (1957) focused on this secondary positive effect and affirmed that a trade-diverting customs union would be beneficial for its members. This statement openly contradicts the conclusions of Viner (1950). It is obvious that the consumer surplus effect may compensate for the negative trade diversion effect on the production side, provided the decrease in local prices is sufficiently large. Meade (1955) and Lipsey (1957) argued that there can be an increase in welfare with trade diversion if the trade diversion is an option to an autarky system where production in a country is protected by a high tariff. Meade (1955) emphasised that as long as trade diversion is an option to no trade, it will increase welfare. Taking into account the relative prices in the countries forming a custom union, Viner's conclusion that trade creation is a "good thing" and trade diversion a "bad thing" should not be final. Bhagwati (1977) goes even further by saying that even if there is zero demand elasticity, a trade-diverting union can lead to an improvement in welfare if one considers that the supply elasticity of the good in country is not infinite.

Meade (1955) and Lipsey (1957) eliminated the hypothesis of consumption in fixed proportions by discussing the effects of the establishment of a customs union on the change in terms of trade between the economies involved. They stressed that if a change in the flows of trade is due to the "substitution" of goods, then a substitution effect in the consumption of goods would tend to increase the volume of imports from the partner country and decrease the imports from the rest of the world; and would make consumers replace the consumption of goods produced in the local market by goods imported from the partner

country, if the establishment of a customs union changed relative prices of the goods in favour of the partner country.

According to Bhagwati (1977) and the Economic Research Bureau (2007) argue that when countries within the customs union end up buying from higher cost producers within the union over the least-cost producers outside the agreement, consumers still benefit. Despite the advantage of reduced tariffs which translate into lower prices of traded goods the national treasury of the customs union members suffers because it will have lost the tariffs that would have been charged. The above argument is especially true for countries whose trade share to Gross Domestic Product is higher and the customs revenue share of the national budget is larger. If gains to consumers outweigh the added amount paid to the producers in the high cost partner country, the result can be a net welfare gain for the country, that is, depending on which is higher. But this is only true if we assume that output of any industry in a particular country increases over the long-run relative to the national economy as a whole, its costs of production per unit also rises. But there are industries where you could get economies of scale returns. But anyway, free traders would argue that there would only be a benefit if this lower cost were even lower than the cost in the international market (before duties).

The theory of regional economic integration has passed through two different periods in history (Krauss, 1972). The first period put emphasis on the impact of customs union formation on production (Viner 1950), consumption (Meade, 1955; Lipsey, 1957) and trade flows. In the period, from 1960 onwards, economists began to question what the real objectives were of those entering integration schemes. Some time earlier, with the development of the second best theory, economists had reached the conclusion that regional economic integration would not lead to maximum welfare gains in comparison to the global integration

which would result from multilateral tariffs reduction. Work by Johnson (1965), Cooper and Massell (1965) and later Berglas (1979) was the most significant in this respect. In fact, until the mid-1970s, theoreticians were fairly sceptical about the economic value of customs union and other regional integration arrangements as they considered them second-best in comparison with the multilateral trade liberalisation advanced by GATT, which has been subsumed into the WTO. With the development of the theory of intra-industry trade in the mid-1970s, new light was shed on the usefulness of regional trade liberalisation.

There was consensus among the theoreticians in the 1970s and 1980s that discriminatory trading arrangements, such as customs unions, tend to be welfare-enhancing for their members provided these trading arrangements are regionally-based and fairly open to new membership and, also on condition that the members acting together are able to influence the terms of trade with the rest of the world (Oye, 1992). Supply-side improvements within the integrating area benefit the non-member consumers (whether final or intermediary) as well as the exporters since fixed costs to penetrate the unified market tend to decrease (Smith & Venables, 1991).

#### **2.4.1 Trade creation and trade diversion in customs union**

The main argument in favour of the customs union (CU) is that it leads to trade creation and economies of scale. Trade creation occurs when low-priced imports from member countries replace high-priced domestic products. Trade creation benefits the efficient producers at the expense of inefficient producers and it results in the expansion of exports and increase in employment. The overall gains depend on the impact trade creation has on the industrial output of the trading block. For example, if the industrial output increases on a bigger scale as a result of trade creation then the gains will be larger, but will be lower when industrial output increases by a small margin.

Major arguments against customs unions include trade diversion and polarisation<sup>8</sup>. Trade diversion occurs when the formation of a customs union encourages members to buy expensive goods within the union at the expense of cheaper goods outside the union due to the price-raising effect and the protective nature of the CET. Therefore trade is diverted from a low-cost source to a high-cost source. This is of concern because it promotes the inefficient use of resources and reduces consumer surplus. The existence of a CET deprives member states of the ability to formulate their own tariff policies. The formation or extension of a customs union will increase welfare if trade creation exceeds trade diversion, and reduce welfare if the reverse is the case.

Baldwin (1995) applied the trade creation and diversion analysis to justify the expansion of the EU (from 1994) to accommodate the former Communist block members from Eastern Europe. The analysis revealed that the chances of trade creation exceeding trade diversion increase if the following conditions are in place:

- The applicant had high tariffs prior to membership, which will be lowered to the level of the customs union.
- The customs union has a low common external tariff.
- Tariffs in the rest of the world, outside of the customs union, are high.
- The customs union is large enough to have an effect on the external terms of trade.
- The trade structure of the applicant is currently competitive with that of the members of the union, but is potentially complementary to them.

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<sup>8</sup> This aspect will be discussed in section 2.4.2.

Baldwin (1995) concluded that the economic gains of twelve new entrants to the EU would not be the same, but it would depend on the structure of their economies in terms of the criteria listed above. For example, Polish farmers might derive more gains<sup>9</sup> in the agricultural sector as a result of lower input costs to their production, namely labour and an abundance of land in comparison to the old EU members such as France and Germany.

With the proliferation of regional trading communities such as SACU, COMESA and the European Union, the question often arises as to whether such arrangements benefit world trade and increase overall welfare? The answer depends on the difference between the trade creation effects and the trade diversion effects of the customs union. Increased specialisation and economies of scale should increase productive efficiency within member countries, thus resulting in higher levels of welfare.

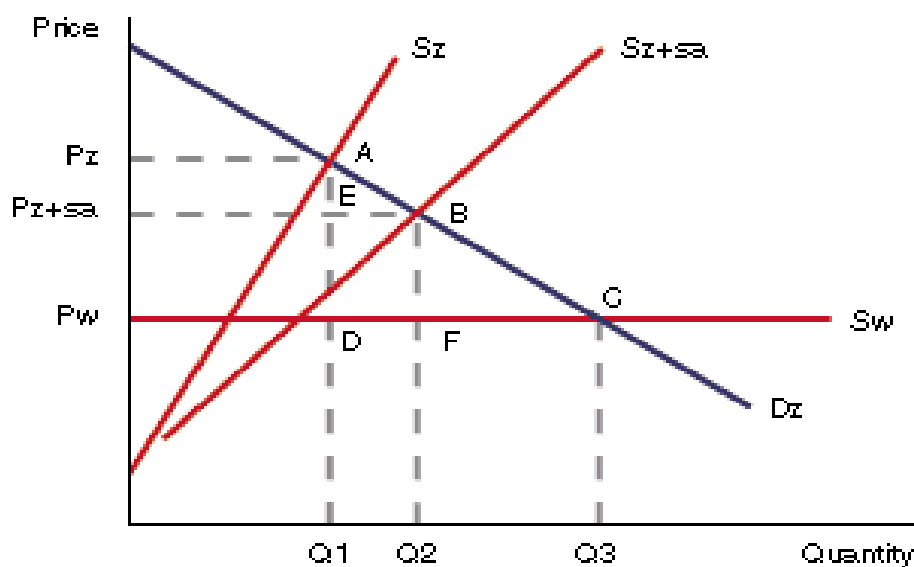
With trade diversion, production will be diverted away from those countries outside the trade bloc that have a natural comparative advantage to those countries within the trading block that have high cost production structures. Figure 2.1<sup>10</sup> shows the trade creation and trade diversion effects which will occur when Zimbabwe forms a customs union with South Africa. Figure 2.1 depicts the trade in maize of the two countries. Supply curve  $S_z$  applies to Zimbabwe before the formation of the customs union. Should Zimbabwe form a customs union with South Africa then the supply curve for maize is  $S_z + s_a$  for

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<sup>9</sup> The economic gains are likely to be a short-term effect as there might be an equalisation of factor prices in the long-term, which might erode the initial Polish economic gains.

<sup>10</sup> This is a hypothetical example as there is currently no customs union agreement between Zimbabwe and South Africa.

both Zimbabwe and South Africa. The world output of maize is shown by the horizontal supply curve,  $S_w$ . The Zimbabwean demand curve for maize is  $D_z$ .



**Fig 2.1: Trade creation and trade diversion in a two-country model,  
Source: Meade 1955**

If the two countries do not trade with each other, the domestic price of maize in Zimbabwe will be  $P_z$  and the quantity of maize produced will be  $Q_1$ . The formation of a customs union with South Africa would mean that the price of maize will fall to  $P_z+sa$  and the quantity of maize produced will increase to  $Q_2$ . The triangle  $AEB$  represents the resulting welfare gain or trade creation effect.

If Zimbabwe were to trade freely on the world market, quantity  $Q_3$  of maize could be purchased at the world price of  $P_w$ . The member countries would not benefit from the low prices of maize from the rest of the world (RoW) because of the existence of the customs union and the imposition of some form of trade barrier, a common external tariff, as represented by  $0P_z+sa$  minus  $0P_w$ . There has therefore been a welfare loss of  $BFC$ . This is the trade diversion effect. A comparison of the two effects enables the overall welfare gain or loss resulting from the

formation of the trading bloc to be assessed. The welfare implication arising from the trade creation and the trade diversion effect are summarised in Table 2.1:

**Table 2.1: A summary of trade creation and diversion in a two-country model customs union**

	With no trade	With the customs union	With global free trade
Price and Quantity	$P_z, Q_1$	$P_z + s_a, Q_2$	$P_w, Q_3$
Trade Creation	-	EAB	DAC
Trade Diversion	ADC	BFC	-

**Source: Lipsey 1957**

According to McCarthy (1999) and Venables (1990) under increasing cost conditions, a customs union or FTA established among small countries, for example, SACU, (which is unable to influence their external terms of trade) will be predominantly trade diverting so long as non-member countries continue to supply imports to member countries. Although the exports of the producers of the member countries to other member countries will be increased under the RIA and these producers will thus enjoy welfare gains, the overall welfare of member countries will typically decline because these countries will be forfeiting substantial tariff revenues and will not enjoy an overall increase in their imports. The welfare of the trading bloc and (equivalently) the world economy will also typically decline as a result of the increased demand for resources necessary to expand exports by member countries.

From the perspective of the developed countries the gains from regional economic integration depend firstly on whether the country forms part of the trading bloc, and, secondly, on which other countries are also members of the trading bloc (Baldwin, 1994). Not being part of a trading bloc will often mean that a country will be prejudiced due to the trade

diversion effect. Yugoslavia, which is not a member of the EU, faces trade barriers such as tariffs when exporting to the EU market and is consequently disadvantaged. However, a customs union comprising developing countries or least-developed countries (LDC) may result in a minimal trade creation effect only as the share of global trade of these countries would be insignificant,<sup>11</sup> and the trade bloc would have a limited influence on the market price and quantity. If an LDC joins a trade bloc comprising developed or middle-income countries then this might constitute a real advantage to the LDC as resources flow within the bloc to the countries where there are cost advantages and the potential market for exports is significantly expanded. This perhaps explains why the developing world is eager to have some form of trade relations with the EU, US and Japan (Coe & Hoefmaister, 1998).

Johnson (1965) and Lipsey (1957) assert that the larger the customs union, the greater the possibility that the most efficient producers of various goods will be part of the customs union and hence the smaller the potential for trade diverting effects. Secondly, when the large customs union fixes its CET rate then the possibility of this tariff rate affecting the external terms of trade increases and thus the customs union is able to obtain an additional welfare gain. For a large customs union, a general tariff imposed on imports may lead to gains in terms of trade and these gains will exceed the negative welfare effects resulting from a decrease in imports to the benefit of domestic production. This is the rationale behind optimal tariff rates.

The net benefit (loss) to a country may be determined by comparing the trade creation and trade diversion effects. If trade creation exceeds trade diversion, then economic integration will enhance the welfare of

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<sup>11</sup> For example, Africa's share of global trade is less than 2 per cent.



the country, but if trade diversion dominates, then the welfare will be reduced.

#### **2.4.2 The polarisation effects of a customs union**

Within a customs union, industries tend to cluster in the relatively more developed member states since these states offer substantial internal and external economies of scale. This phenomenon is known as polarisation and is even more probable when huge discrepancies in the levels of economic development between member states already prevail. This has been the root cause of the limited success of integration efforts in developing countries. For example, in SACU, South Africa is the most advanced economy and thus attracts more investment than the other four member countries. The higher purchasing power in South Africa, comparably lower transport costs within the South African market and the perception of higher risks in Botswana, Namibia, Lesotho and Swaziland (BLNS) also contribute to the tendency of industries to cluster more predominantly in South Africa.

While there is no evidence that under-development in SACU has been caused by the polarisation effect, others argue that South Africa used its dominant power in the institutions to develop its own economy and thereby strengthened polarisation.

The redistributive mechanism, known as the revenue sharing formula, is largely perceived by the BLNS countries as compensation by South Africa, as it has forced them to consume South African goods that are more highly priced than goods from the rest of the world (Venables, 1990; Baldwin, 1995; McCarthy, 1999; 2004).

### **2.4.3 The impact of customs union on economies of scale**

Economies of scale occur when the average cost of producing a larger quantity is lower than the average cost of producing a smaller quantity. The argument in favour of creating regional economic communities (RECs) is the improved exploitation of scale economies which are not possible in small national markets. The benefit of economies of scale has enabled countries to concentrate production in fewer, larger plants, for example, the formation of Airbus (an aircraft producing industry owned jointly by Britain and France) was a result of EU integration. By combining synergies Britain and France are able to compete with the Boeing produced in the United States and the consumers stand to gain because the resultant competition in the industry lowers the prices of aircrafts. However, this is a general argument in favour of trade liberalisation or for worldwide free trade. It must be borne in mind that everything obviously depends on the type of product under focus and on the relative size of the national market when compared to the market of the union (Salvatore, 1990).

Global trade is dominated by large firms that have reaped static and dynamic economies of scale within the larger regional market. Economies of scale enable the firms to meet greater market demand by moving down their long-run average cost curves. The economies of scale are significant for all customs unions, and include unions consisting of countries from both developed regions such as the EU and developing regions such as SACU (Balassa, 1961; 1976; Baldwin, 1994; McCarthy, 1994).

In the 1970s the scale economies argument was combined with the theory of intra-industry trade which had been developed initially by Grubel and Lloyd (1975). Grubel and Lloyd (1975) observed both intra-EC trade in differentiated products and the related intra-industry

specialisation, and concluded that this is probably due to a concentration of local EC producers in particular production lines and models once they have been assured that they will enjoy a quasi-monopoly in the whole EC market in terms of the particular brand they produce. Not surprisingly, in the 1980s the scale economies argument was progressively linked to new models of international trade under imperfect competition, drawing abundantly for their design from industrial economics (Krugman, 1991; Venables, 1990).

If the initial assumption is that there were unexploited economies of scale before (regional) trade liberalisation, then the latter would increase concentration and firm scale, and ultimately justify mass production which is incompatible with perfect competition. After a quasi-monopoly in differentiated products has been established in every partner country, then the latter may be tempted to increase the prices in order to realise the super-normal profit whilst reducing the consumer welfare. Clearly there may be a sufficient inducement for implicit or explicit collusion to take place under certain circumstances.

However, Smith and Venables (1991) demonstrate that the gains of removing intra-union trade barriers in such a setting (described in the paragraph above) are generally modest. They maintain that the difference lies in the fact that nationally-based monopolistic firms prevailing before the union was created will not be able to continue to apply a price-discriminating strategy; market segmentation is not feasible. On the other hand, local firms will no longer be able to dispose of goods across borders at prices below cost – something they are able to do whenever they are able to cover losses by selling domestically at monopolistic prices. The forced reduction of domestic prices and the increase in intra-union export prices leads to diminished, rather than increased, intra-union trade (Krugman, 1979; Venables, 1990).

On the other hand, the new theoretical developments indicate a different direction as far as trade policy is concerned. In the world of decreasing returns "first mover advantages"<sup>12</sup> are critical. The temptation for government is then to intervene in order to promote production in the desired field and pre-empt the entry of competing countries. This is what economists term 'strategic trade policy' (Krugman, 1986). However, when sovereign countries decide to integrate they are, in fact, indicating that they foreclose autonomous intervention, that is, that they renounce the implementation of individual trade policies. They prefer (or accept) that intervention be carried out at the level of the customs union.

#### **2.4.4 The impact of regional economic integration on the terms of trade**

When analysing the experiences of the EU integration, the theoreticians, throughout the 1960s and early 1970s, made the mistake of assuming that prices in foreign markets were given and ignored the terms of trade effects and ultimately made unilateral tariff dismantling the optimal policy. Vanek (1965) argued that it is not possible to explain integration agreements if one does not take into account the benefits that discrimination holds for the discriminators, which he referred as the terms of trade effects. Terms of trade effects were examined in detail by Mundell (1964) and Vanek (1965) and far more thoroughly by Kemp (1969) and Negishi (1969).

Pearce (1970) summed up all by stating that the terms of trade with the rest of the world allows for the redistribution of world income in favour of the member countries of the customs union. In contrast, the neo-

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<sup>12</sup> The ability of the firm/industries to be the first to enter the new market. Such industries establish a monopoly position and create barriers to entry for firms wishing to enter the market.

classical alternative of unilaterally dismantling tariffs on a non-discriminatory basis will not improve the terms of trade and may even lead to deterioration, rather than an improvement. In reality the creation of a customs union for this purpose is similar to introducing an optimal trade restriction at national level. The formation of a customs union may be particularly advisable for small countries which would not be in a position individually to affect the terms of trade. Joining a customs union enables a country to do what it cannot do alone (Pearce, 1970).

Vanek (1965) reached the conclusion that the country which, before the union, traded mainly with its future partner was likely to gain from the integration, whereas partners with large trade stakes in the rest of the world would lose, unless the latter were able to improve their terms of trade with the rest of the world through trade diversion in such a way as to compensate for the deadweight loss derived from being forced to switch supply sources. However, any improvement in the terms of trade depends on the relative size of the union in relation to third countries.

Kemp (1969) expanded on his previous analysis by stating very simply that customs union formation would make a positive contribution to world welfare (thus contradicting Viner) in as much as it were also possible for the partner which gains to compensate fully the loser within the union and the non-members outside of the union, and yet still be better off.

This could always be achieved first by a series of intra-union lump sum transfers and then by selecting the correct CET instead of assuming that the latter would be equal either to the tariff which had prevailed prior to the customs union formation in the importing country or to an arithmetic average of the tariffs of the members before formation of the union.

## 2.5 Approaches to regional economic integration

There are three main approaches to regional economic integration, namely, regional cooperation, market integration and development integration. According to Mistry (1996:52) and Venables (1990), of the three approaches mentioned above, regional cooperation has been perceived to present a softer option as it allows respective players room for flexibility. Regional cooperation consists simply of cooperation and collaboration between countries on matters of mutual interest. For example, the India, Brazil and South Africa Forum (IBSA), is an agreement between the three continental powers whereby cooperation in certain sectors of the economy is the overriding objective.

The Southern African Development Coordinating Conference (SADCC)<sup>13</sup> adopted regional cooperation throughout the 1980s as a strategy which was geared towards lessening dependence of the region on apartheid South Africa. Apart from its success in uniting the region against the apartheid government of South Africa, the regional cooperation efforts on the part of SADCC did not result in much socio-economic development. However, regional cooperation may indeed lay the foundations for deeper market integration as has been witnessed in the European Union in which cooperation in the areas of coal and energy production (in 1952) graduated into a fully fledged economic union more than four decades later (Mistry, 1996: 56; Njikeu & Gitongo, 2005).

However, from a theoretical perspective, there are two competing visions of regionalism and regional integration models. The first of these is the market or liberal-led integration model or open regionalism, which

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<sup>13</sup> SADCC was renamed the South African Development Community (SADC) in 1992. It comprised the current SADC countries with the exception of Madagascar, Namibia and South Africa.

elevates the market, and is the self-regulating mechanism (SRM) within society. It is based on classical or neo-classical economic theory which states that the market should drive the economic integration processes. The other vision, closed regionalism, places less emphasis on the market, and stresses that the objective of integration is the achievement of social and economic development (Njikeu & Gitongo, 2005). Both market and development integration models require that the following conditions prevail in order for success to be ensured (Krueger, 1997; Mistry, 1996; Viner, 1950):

- Harmonised national macroeconomic policies.
- Regional macroeconomic stability based on a certain agreed criteria.
- Some degree of regional political stability.
- Significant intra-regional trade.
- Complementary industrial development among member countries.
- Significant distribution of the benefits of integration.
- A political willingness to share a certain level of sovereignty.

### **2.5.1 Market integration**

Market integration refers to a process that moves progressively through different stages and degrees of linear integration (from the Free Trade Area, Customs Union, Common Market and Economic Union), and finally achieves the ultimate goal of political union. Historically market integration has been associated with the theory of customs union as developed by Jacob Viner in his seminal work, *The customs union issue* (Viner, 1950). Viner defended the neo-classical free trade theory, which insisted on unhindered free trade without regional barriers throughout the world. Viner argued that the regional exchange of goods and services would be beneficial to all the parties within a customs union as long as trade was created. Such exchange, he argued, would enable the most efficient producers to take a major share of the market, and to

replace the less efficient producers. Although the latter would disappear from the market he argued that this would nevertheless be beneficial in that the most efficient producers would reduce the unit costs of production, resulting, in turn, in lower prices for consumers throughout the customs union. This would lead to an increase in trade within the union as a whole, and would therefore constitute a trade-creating customs union (Viner, 1950; Musila, 2005; Vickers, 2006).

Baldwin (1994) and Bertelsmann and Draper (2006) emphasise that the EU is an example of fully functioning market integration in which the national economies are integrated and intra-regional trade is more than 60 percent of the EU total trade. The EU progressed through the developmental integration stages which were aimed at economic development, such as building up the industrial base and infrastructure which had been destroyed during the First World War (WWI).

According to Baldwin (1994) and Lawrence (1995) the EU integration process was incremental and the EU refrained from setting up ambitious targets which were not achievable. In contrast, developing countries have a tendency to create timetables for the achievement of the upper end of integration without due regard for developmental challenges such as infrastructure development and the prevailing socio-economic circumstances. Many of developing RIAs fail to reach the objectives set.

### **2.5.2. Development integration**

Development integration emerged as a process to address market failure in the provision of goods and services. This approach recognises that, when market forces are unleashed on society, their tendency is to produce inequalities and widen the economic differences between the



lesser developed and the more developed areas. Furthermore, when the investment risk is high the market is unable to supply public goods. This is even truer for large projects such as the construction of roads, harbours, dams and so forth which are long-term projects. Development integration seeks to correct the situation by recasting the terms of the integration process. It does this by focusing on redefining the objectives of the integration process, addressing the controversial question of the distribution of the costs and benefits of regional integration, and by addressing the issue of timing and the level of inter-state binding commitments (Freund, 2000; Oyejide *et al*, 1999).

Foroutan and Prichett (1993:1323) emphasise that the objective of the integration process is defined around the issues of economic and social development. The integration model is linked to the theory of development and the symbiotic relationship between the state and market to produce the desired outcome. Secondly, deliberate efforts have to be made to ensure that compensatory measures are in place, to compensate member states that become worse-off as a result of the agreement. Without compensatory measures, the integration project is unlikely to take off. Compensatory measures might assume different forms, for example, in the Southern African Customs Union (SACU) there is a revenue sharing mechanism in terms of which member states share the customs and excise revenue based on SACU intra-trade. The SACU mechanism has worked with some degree of success, even though the recipient countries, in particular, Botswana, Lesotho, Namibia and Swaziland, have been far from satisfied.

Thirdly, a high level of political commitment is required for all these processes to commence. Whereas market-led integration relies less on the states and political intervention, developmental integration seems to stress the primacy of the state. Developing regions must undertake development integration as a first priority, as it will ensure that

economic development and socio-economic conditions, such as poverty and unemployment, will be addressed before the developing regions move into higher stages of linear integration (Mistry, 1996: 49; Bertelsmann & Draper, 2006).

## **2.6 Preconditions for successful regional economic integration**

Member countries of the regional economic community must abide by the collective rules that regulate and govern the behaviour of member states. The European Economic Community (and later the European Union) was the first RIA to establish such rules in the form of convergence criteria, which govern the behaviour (as far as fiscal and monetary policies are concerned) of member countries and determine eligibility to join the Euro zone. A member country must satisfy the preconditions in order to qualify to be a member of the monetary union and adopt the Euro<sup>14</sup> currency (Baldwin, 1994 & 1995).

Developing countries also have a set of conditions (usually adopted from the EU convergence criteria) that need to be met before the RIA graduates from one form to another, i.e. from an FTA to a customs union. The problem of adapting the set of conditions as applicable to a developed RIA (such as EU) to apply to a developing RIA, such as the SADC, is that the country might have a trade-off between the requisite development and fiscal austerity that is necessary to achieve macroeconomic convergence (Committee of Central Bank Governors, 2007; McCarthy, 2002).

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<sup>14</sup> The Euro is the currency of trade for the thirteen members of the EU who, since 1999, have qualified under the convergence criteria as set out in the Maastricht Treaty of 1992.

### **2.6.1 Convergence criteria**

According to McCarthy (2002) economic convergence refers to the phenomenon of catch-up growth, that is, less developed economies catching up with rich(er) countries in terms of development indicators such as per capita income. The pursuit of macroeconomic convergence, which by definition entails the setting of lower and/or upper limits for selected macroeconomic variables, is usually underpinned by the desire to guide certain key aspects of future economic and financial policy and its management among the member countries concerned.

McCarthy (2002) further stresses that macroeconomic convergence serves as an eligibility test in terms of which only those countries that attain the convergence benchmarks would qualify for membership of an economic grouping. Another reason for seeking macroeconomic convergence is the advantages that macroeconomic convergence confers on members, either individually or collectively. These advantages may include the attainment of macroeconomic stability, for example, through sustainable fiscal deficits and public indebtedness, external current account deficit, as well as low and stable levels of inflation, which are among the key pre-conditions for achieving strong and sustainable economic growth.

According to Ajayi (2005) and the Economic Commission for Africa (2005) both developed and developing regions have macroeconomic convergence criteria in place, although those of the latter would have been copied from the former, for example, the convergence criteria or guidelines for membership of SADC mirror those of the EU, even though the target levels differ. Usually a regional power(s) will become the custodian of the agreed rules as the regional power(s) will be in a position to administer rewards and punishment to other smaller

members and at the same time the smaller members can collectively impose rewards and sanctions. It is highly unlikely for smaller members collectively or alone to impose sanctions on a bigger member. However, deviation by the regional power and the failure to impose sanction on the deviating member state might undermine the whole system (Siggel, 2005; McCarthy, 2002).

### **2.6.2 Convergence criteria in RIAs among the developed countries**

The current monetary union in Europe embodied in the European Central Bank and a single currency for member countries originated in the Delors Report completed under the auspices of the French Minister of Finance of the time, Mr Jacques Delors (Salvatore, 1990; Baldwin, 1994; Siggel, 2005). This report put forward concrete proposals for a European economic and monetary union anchored in pegged exchange rate for the currencies of member countries before the introduction of a single currency.

The next important milestone for European monetary convergence was the ratification on 7 February 1992 of the Treaty on the European Union, generally referred to as the Maastricht Treaty. In terms of this treaty, selected macroeconomic indicators would be targeted in the following manner (Baldwin, 1994):

- Inflation rates not higher than 1, 5 per cent above the average inflation rate of the three countries in the Union with the lowest inflation rates.
- Long-term interest rates may not diverge by more than 2 per cent from the interest rates in the three countries with the lowest inflation rates.

- The annual budget deficits of the governments of the countries in the Union may not exceed 3 per cent of the GDP of the relevant country.
- Government debt may not exceed 60 per cent of the GDP of the relevant country.
- In the period prior to the acceptance of the Euro as a single currency, the exchange rates of member countries of the Union should stay within the accepted exchange rate target range. The country concerned must be a member of the exchange rate mechanism for two years.

Member countries of the EU still experience difficulties in meeting these criteria. By 1999<sup>15</sup> Luxembourg was the only EU member country that had met the four most important criteria (inflation, interest rates, budget deficit and government debt). It was not expected that France and Germany (Euro zone powers) would flout the rules of the convergence criteria, but they exceeded the limits in the period 2002 to 2004 by spending above the 3 per cent deficit ceiling. Smaller countries have taken their cue from the behaviour of the larger powers, and Greece and Portugal have also flouted the rules (European Central Bank Convergence Report, 2004).

Although there are sanctions that may be imposed on a member country deviating from the criteria set, it has proved to be difficult for the smaller EU member countries to punish the larger EU powers who have flouted the rules. It is important to note that, as soon as a member state deviates from the macroeconomic convergence criteria, the member state must devise a plan in order to return to the accepted behaviour.

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<sup>15</sup> At the time of the introduction of the Euro.

Furthermore, there is an understanding that any deviation from the macroeconomic targets will have a negative effect for all member countries, as investors regard the EU as one single market.

### **2.6.3 Convergence criteria among the developing countries**

It should be noted that, in line with the Abuja Treaty resolution of 1991 aimed at accelerating regional integration in Africa, all African regional economic communities have adopted the macroeconomic convergence targets aimed at achieving the Africa Economic Community. Although the target points differ, the targeted indicators for the economic communities in Africa are similar to those of the EU:

- Abdoulai (2005) and Aryeetey (2000) confirm that, on 20 April 2000 in Accra, Ghana, the heads of state of the Economic Community of West African States (ECOWAS), with the exception of Liberia, ratified a declaration for the establishment of the West African Monetary Zone (WAMZ). The aim of the WAMZ is to carry out all those functions necessary for the establishment of a monetary union, the establishment of the West African Central Bank (WACB) and the introduction of a common currency, the ECO, for member countries (WAMZ). The primary macroeconomic convergence criteria set for member countries of the WAMZ comprise the following:
  - i. Single digit inflation by 2003 and an inflation rate of 5 per cent by 2004, which has not been achieved.
  - ii. Stable fiscal position for governments of member countries by limiting the budget deficit, excluding grants, to 4 per cent or less of the GDP in the period 2003 to 2005, which has been achieved by Nigeria and Ghana.

iii. Limit central bank funding of the budget deficit to 10 per cent or less of the tax income of governments in the preceding tax year for the period 2003 to 2008.

iv. Sufficient gold and foreign exchange reserves to cover at least 3 months' imports for the period 2003 to 2005. This was achieved in 2006, after the target date.

- The West African Economic and Monetary Union (or WAEMU), which comprises Benin, Burkina Faso, Guinea-Bissau, Ivory Coast, Mali, Niger, Senegal and Togo, adopted the macroeconomic convergence criteria set out in 1999 in terms of the Convergence, Stability, Growth and Solidarity Pact for member countries. According to Diagne (2005), and Masson and Pattillo (2005:3), WAEMU member states agreed to achieve the following: price stability with an inflation rate of 3 per cent; the basic fiscal balance (income excluding grants minus current expenditure) of member countries should be in equilibrium or positive. Government debt in member countries should be lower than 70 per cent of the GDP.
- The Central African Economic and Monetary Community (CEMAC), which comprises Cameroon, the Central African Republic, Chad, Equatorial-Guinea, Gabon and the Republic of the Congo, signed a treaty in March 1994 to provide for the promotion of the process of sub-regional integration within the framework of an economic union and a monetary union and accepted the same convergence criteria as the WAEMU countries, including the principle that monetary financing of governments be limited to 20 per cent of the previous year's budgetary revenues (Ajayi, 2005; Akamanzi, 2006; IMF, 2007).
- The convergence criteria of the SADC also target the same macroeconomic indicators as the EU, but differ in respect of the

Since the adoption of the macroeconomic convergence target indicators, only South Africa has managed to meet all the targets (although inflation is in single digit, at about eight per cent, it is above South Africa's inflation target regime, which requires inflation to be between three to six per cent). In view of the level of asymmetry in development in the region, it is unlikely that the other members will meet all the targets in the short-term given that their economies still have the capacity to expand and will need cheap credit for entrepreneurship (this will necessitate lowering interest rates which is inflationary and can lead to higher levels of debt to GDP ratio, which exceed the targeted level).

In addition, SADC member countries do not possess the required funding to expand their production and they depend on borrowing from the international market. International borrowing will increase the government debt to above 60 per cent (which is the targeted level) and furthermore will lead to an increase in government expenditure beyond the target 3 per cent.



Although the outlook is not good, the member countries could concentrate on one target (such as inflation targeting) at the moment and then add other indicators as they go forward, or when their economies are growing and they have at least addressed the developmental challenges such as infrastructure development, socio-economic gap and the reduction of poverty, all of which require foreign borrowing (McCarthy, 2002).

#### **2.6.4 Criticism of convergence criteria in developing countries**

The main criticism of the convergence criteria of developing countries is that they have been copied from the developed countries (such as the EU) without any regard for the economic structures of the developing countries. Since the economies of the developing regions are at various levels of development, the time envisaged for an RIA to graduate from one form to the other is very short and does not allow for per capita income convergence or for the strengthening of institutions to regulate the behaviour of member states, for example, the period in which SADC should graduate from an FTA to monetary union is eight years.

This time period for SADC to graduate from an FTA to a monetary union is not comparable even to that of the EU that has evolved into a monetary union in a time span of fifty years. McCarthy (2002) states that, although convergence is a requisite for monetary integration, SADC is not ready for this step in regional integration, especially with regard to public debt as a percentage of GDP, single digit interest rates and the budget deficit which has been targeted at a lower rate. Furthermore, the removal of the exchange rate and the rate of interest from the portfolio of policy instruments of each member state will restrict the ability of each state to manage external shocks.

The economic disparities between SADC member countries and sub-region mean that a fully-fledged macroeconomic convergence programme is not appropriate at this stage of SADC's development. However, it may be argued that an adapted single indicator programme (such as monetary policy anchored on inflation targeting) would be beneficial. Macroeconomic stability requires sound and credible fiscal and monetary policies, and this is something that SADC member states lack. Experience has shown that many SADC member states resort to printing money in order to stimulate the economy, for example, the Zimbabwean government printed money to deal with economic decline and this has led to hyperinflation (Jebuni & Soludo, 1995; Rowthorn & Richard, 1998; Southern Africa Development Community Report, 2006).

#### **2.6.5 Proponents of fiscal and macroeconomic convergence**

On the other hand, proponents of fiscal and macroeconomic convergence believe that the SADC region is ready for this experiment. They further reiterate that EU countries continue to deviate from the Maastricht criteria without damaging the economic prospects of the other member states. The benefits of such criteria far outweigh staying out of such convergence. In the EU the larger economies, such as France and Germany, have a problem reducing the deficit to the acceptable level of EU standards, which is less than 3 per cent. There are, however, sanctions which may be imposed on these larger members by the smaller members, but the latter choose to allow countries some leeway in returning to the accepted levels of behaviour. The advantages of a similar interest rate, low inflation rate, and so forth, which are inherent in membership of the Maastricht convergence criteria, have benefited smaller countries, such as Greece and Portugal, and they would not have achieved the feat, if they had opted out (Mboweni, 2003).

For developing RECs, preconditions such as macroeconomic convergence criteria may be used to align the region with major trading partners, to attract foreign direct investment as well as to prepare the member countries for a deeper level of integration such as the monetary union. The convergence criteria used by developing RIAs should not necessarily mirror those of developed RIAs, such as the EU, but the convergence criteria of developing RIAs must be informed by the level of economic development in the region and must take cognisance of the economic disparities that characterise the economies of such a region.

As with the exchange rate mechanism of the EU (in terms of which currencies were anchored to the German Mark), the currencies envisaged in developing RIAs must be anchored to a strong currency, for example, the SADC currencies could, as a transition towards the envisaged common currency, be anchored to the South African Rand.

RIAs should be flexible with regard to timeframes set for achieving different milestones of linear integration. For example, if the conditions set for achieving a SADC customs union by 2010 are not realised, the regional leaders should not hesitate to shift the objective to the latter date if there if the problems encountered are beyond the region's control. So saying, however, there is a need for a form of convergence in developing RIAs that is informed by the actual situation on the ground. In addition there should be a political willingness on the part of the leaders of developing RIAs and the citizens to support the process (EC Report, 2005; Mboweni, 2003).

## **2.7 Conclusion**

It has been demonstrated that regional trade arrangement would be desirable if such an arrangement were trade-creating and welfare-

enhancing. On the other hand it would be undesirable if it were trade-diverting and welfare-reducing. The overall effects of a RIA (in particular a custom union) are not always positive and depend on whether the RIA creates trade and increases the welfare of the regional members. Should a RIA be trade-creating among member states (even if the effect to the rest of the world is welfare-reducing) then such a union will be judged to have a positive impact since it will have resulted in certain welfare gains in member countries. Although RIAs are discriminatory in nature they are permitted under GATT Article XXIV, which allows for the formation of an RIA if it aims to liberalise all trade within a reasonable given time or if it covers all trade rather than just a specific sector of trade.

Convergence criteria are a set of conditions by which each member state of the RIA must abide if the RIA is to graduate from one form to another, for example, from a customs union to a common market and a monetary union. Critics have found that RIAs from the developing world adopt the same convergence criteria as those of developed countries, irrespective of their level of economic development. It was found that preconditions are desirable as they enable an RIA to benchmark with its major trading partners. It was cautioned that the RIA should set conditions (convergence criteria) at a level which takes cognisance of economic disparities and which are achievable.

## CHAPTER 3: THE THEORY OF REGIONAL ECONOMIC INTEGRATION IN THE DEVELOPING WORLD

### 3.1 Introduction

On the whole, developing regions<sup>16</sup> have had their fair share of participation in regional integration arrangements. Most RIAs in developing regions, in particular in Sub-Saharan Africa (SSA), have failed to yield the economic benefits that are accruable to the members of regional economic communities. Although the theory of regional economic integration (read customs union) implies that gains, such as an increase in economic welfare and increased markets through scale economies, may be realised by member states, the experiences of developing regions reveal that there were in fact few tangible benefits.

Developing countries formed the RIA in response to events in the developed regions, for example, after the formation in 1957 of the European Economic Community (subsequently the European Union); developing regions replicated the experience without setting up the necessary preconditions that would allow the RIA to flourish (Rodrick, 1998).

In Chapter 3, the focus will be on the theory of regional economic integration as it applies to developing regions by concentrating on the rationale for RIA formation, how RIA formation differs according to the experiences of developing regions, and the measurement of successful regional integration.

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<sup>16</sup> Developing regions comprise countries that have not yet achieved a significant degree of industrialization relative to their populations, and which have a low standard of living in comparison with the developed world. The term is used to define most countries in Sub-Saharan Africa, South Asia, Latin America as well as Caribbean and Pacific regions.

## **3.2 Regional economic integration in developed versus developing countries**

### **3.2.1 Replicating the experiences of developed regions**

According to Economic Commission for Africa (2005) and Mistry (1996) economic integration in the developing world differs from that in the developed world in that it is pursued with the aim of fostering economic development, industrialisation and the reduction of poverty. In developed economies, conditions are such that member countries have already reached a high level of economic development and industrialisation before pursuing higher levels of linear integration. In developed economies regional economic integration is pursued with the objective of attaining higher economic growth and sustaining it through production on a regional scale. For example, industrialisation in Western Europe preceded the formation of the European Economic Community (EEC) in 1957, whereas in Africa, countries participate in an RIA in order to attain industrial and economic development.

Developed regions/countries have been active participants in globalisation and this has helped them to pool regional resources in order to deal with the harsh realities of globalisation. Developing regions, on the other hand, consolidate regional integration in reaction to the forces of globalisation. For example, African countries experienced a dwindling market share of the world economy and pooled resources in order to arrest the decline in their economies and improve the terms of trade, hence the current mushrooming of regional economic communities (De Melo & Panagariya, 1993).

The experiences of one type of regional economic community may not always be relevant to others. Langhammer and Hiemenz (1990) emphasise that in developing region, there is a tendency by

government to replicate the experience of industrialised regions in the way regional integration is pursued. Furthermore, they argue that the notion that the experiences of RIAs in developed countries may easily be replicated in developing countries is a “fallacy of transposition”<sup>17</sup>.

According to Langhammer and Hiemenz (1990) preconditions contributing to integration in Europe, have been overlooked by the governments in developing regions, for example, a higher level of intra-regional trade before the commencement of integration; similarities in income and industrialisation levels allowing for intra-industry specialisation; political geniality in foreign affairs; and both the capability and willingness to provide compensation payments to compensate for different levels of development among member countries. Since the necessary conditions (such as those mentioned above) for regional economic integration were not in place, developing regions, especially, SSA have subsequently achieved very little (in comparison with the developed region) in terms of accruing the benefits of regional economic integration.

### **3.2.2 The orientation of regional economic integration**

RIAs, whatever their specific structure, also vary in their end goals. Krugmann (1984), Krueger (1997) and McCarthy (1994) assert that a distinction has to be made as to whether a RIA has been established to support an inward-oriented (based on import-substitution industrialisation) or outward-oriented (export promotion) trade strategy. Many RIAs in developing countries are inward-oriented in that they were established in order to enlarge the domestic market for import-substituting firms in what members usually refer to as a strategy of self-sufficiency. In terms of these arrangements, protected domestic firms

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<sup>17</sup> A misleading notion that is without justification.

operate on a regional rather than national level. In respect of inward-looking RIAs, industries are chosen and given protection through tariff increases in the substitute imports market to allow a chosen industry, referred to as an infant industry, to grow (in a specified period of time) so that it may compete with similar industries from outside the region.

By contrast, outward-oriented RIAs are often established as a first step towards integration with the global economy. Such RIAs are designed to expose firms to regional competition with a view towards eventually competing in global markets (Salvatore, 1990; Baldwin, 1994; Siggel, 2005). Despite clauses in the treaties of developing RIAs emphasising the need for the outward-oriented model of integration, impediments to real economic integration in the form of high tariffs and technical barriers remain in place.

According to the Economic Commission for Africa (2005) the lack of complementary goods produced in many developing countries has resulted in lower intra-regional trade as the bulk of Sub-Saharan trade is with countries outside the subcontinent<sup>18</sup>. Another deficiency in respect of the RIAs in developing regions has to do with sectoral coverage.

RIAs in the developing world, in particular Sub-Saharan Africa (SSA), are limited to industry and, more specifically, to manufacturing. A minority encompasses agriculture and services. In general, the more limited the agreement, the greater the likelihood that it will exclude those sectors, such as agriculture, in which more countries have a

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<sup>18</sup> The European Union, the US and East Asia (in particular China and India) are the major trading partners of the African continent.



comparative advantage, and this obviously reduces any potential gains from increased regional trade.

### **3.2.3 The measurement of successful regional economic integration**

According to Schiff (2002) and the SADC Report (2006) regional economic integration in developing and developed economies differs in terms of the instrument used for measuring success. In developed regions, the success of regional economic integration is measured using per capita income (in terms of the narrowing of the income gap between the population from industrialised and poor areas), output expansion measured in gross domestic product (GDP), the levels of intra-regional trade and specialisation in production. In addition to those instruments that are applicable to developed regions, the success of RIAs in the developing world is measured in terms of economic development programmes, such as the reduction in poverty, human development (measured by the Human Development Index) and infrastructure developments.

The difference in the instrument that measures either the success or lack of success of the integration schemes of developed and developing economies does not mean that the developing regions are not able to attain the benefits of RIAs that are attainable in the developed regions – it merely illustrates the different levels of development between the two regions. That which the developing regions seek through regional integration would have already been attained by developed economies prior to regional integration (Shams, 2005; SADC Today, 2006).

MERCUSOR and ASEAN, although developing RIAs, have member countries that have attained a higher level of economic development

through regional integration. This may be attributed to the orientation of the RIAs which were export-oriented, open to new members and successful in the production of low-cost manufacturing in sectors in which they have a comparative advantage. It will suffice to say that once developing regions have reached higher levels of economic development measured in terms of infrastructure development and reduction of poverty, the measurement instruments used to gauge regional integration in developed regions will be applicable to developing RIAs (Viner, 1950; McCarthy, 1994).

### **3.2.4 The rationale for a customs union in developing regions**

The aim of creating a customs union is to enable partner states to enjoy economies of scale with a view to supporting the process of economic development. Unlike developed countries, economic integration in developing regions is not merely for purposes of trade, but is a vehicle for bringing about more rapid economic development. Nevertheless, a customs union on its own will not bring about economic development. Accordingly, a customs union has to be supported by other measures such as the development of infrastructure to link production areas to markets. In addition, measures to support the development of human resources across the region are similarly important (SADC Report, 2006).

According to Foroutan and Pritchett (1993) and McCarthy (1999) one of the most compelling arguments in favour of regional integration in developing countries is usually made on the basis of the fragmentation of national economies, for example, Sub-Saharan Africa has 47 small economies with a combined GDP of US\$600 billion, which is equal to that of Belgium or 50 per cent of the GDP of Spain. This is in contrast with the SSA population of about 600 million inhabitants to Spain's 50 million. The small domestic markets, combined with generally high

production costs and deficient investment climates, result in limited investment (Africa attracts less than 2 per cent of global foreign direct investment). The solution to this fragmentation of individual markets is the formation of RIAs, in terms of which member countries may benefit as a result of larger markets in which goods and services are traded at lower or zero tariffs. The customs union is more attractive to developing regions as it has potential to redistribute wealth (derived from import duties from extra-regional imports) in favour of poorer regions. Furthermore it provides for a captive market to test goods that could have otherwise been unable to compete in the wider global market.

### **3.3 The characteristics of a successful regional economic integration agreement**

A successful regional integration is based on a number of preconditions. Integration must be guided by principles, which would ensure that the regional and the national programmes are compatible and mutually reinforcing. One such principle is open-regionalism, which seeks to ensure that a regional strategy is couched in the same ideological paradigm as the national reform policies. The principle of subsidiarity provides guidelines for dividing responsibilities between countries and regional organisations in order to facilitate the integration process. Another principle, that of pragmatism/gradualism indicates that, given asymmetry in the development of member countries, integration may proceed gradually so as to build on demonstration cases and minimise the frequency of policy reversals.

#### **3.3.1 Open regionalism**

Broadly speaking, open regionalism means a coordinated integration rather than a collective retreat from the world economy for countries of the region. Regional programmes must be outward-oriented, market-driven and private sector-led – all of which comprise the constituent

pillars of national reform programmes (McMillan & McCann, 1981). It is precisely this need to reinforce the national programmes that has led to the current resurgence of regionalism worldwide. Without outward orientation as an explicit goal, many regional integration arrangements may tend to raise rather than lower external tariffs, partly as a result of the consensual internal decision-making process, or as the by-product of the increased power of lobbies. For example, in a customs union of which each member country has an interest in raising protection in one sector and reducing it in all others, the consensual internal decision process may lead to a classic “prisoners” dilemma outcome with high protection in all sectors, even though each member country would be better off with low protection in all sectors. Protectionism may also arise as the result of the increased power of lobbies, as the larger scale of activities may also increase stakes and hence raise the opportunity value of lobbying. The following are some of the characteristics of open regionalism (Keck, 2004; Lawrence, 1995; McCarthy, 1999:380; McCarthy, 1994; Mistry, 1996; Teunissen, 1996; Viner, 1950; World Bank; 2000):

- RIAs must be outward-oriented, which means that regional policies must contribute to lowering and eliminating obstacles to global trade and investment, including tariff and non-tariff barriers to the rest of the world in order to ensure accelerated growth in the region. High levels of protectionism not only raise costs for both producers and consumers, but also systematically discourage investment in export-oriented activities and inhibit economic transformation. Thus, lower and more uniform tariffs, the total elimination of non-tariff barriers, and the concomitant reforms of domestic taxation must remain on the agenda of regional programmes.
- Secondly, open regionalism implies a market-driven integration process, which means that governments should refrain from developing national monopolies. RIAs should embark on a

strategy to develop a regional-focused competition policy which regulates anti-competitive behaviour, for example, the EU has such a body. National monopolies constitute restraints on competition, free trade and investment, and the thrust of national reform programmes is, among other things, to eliminate national monopolies. However as the market expands beyond national boundaries as part of the integration process, the region must guard against the emergence of regional monopolies, which tend to reduce consumer welfare as result of collusion in setting up the prices of goods. Instead, countries must cooperate to expand markets and competition across borders. This is obviously the essence of a common market. However this must go beyond traditional goods market integration (FTA, customs unions, etc), and extend to infrastructure services, which have traditionally remained the domain of national monopolies and which are now the targets of national privatisation and liberalisation programmes, especially in developing regions.

- The very idea of a well-functioning market implies private sector involvement. Ultimately, integration is for the benefit of the people of a region – they should be the critical actors, and governments and regional organisations merely facilitators through appropriate choices and policies. Enhanced production and trade of goods and services are dependent on the improved performance of private firms and farms, and private operators and consumers will be the main beneficiaries of larger markets and improved investment opportunities.
- This also means that private operators must be involved in the design and implementation of regional activities, and this will also help change the widespread perception that regional organisations are simply remote outgrowths of government bureaucracies rather than instruments for empowering the private sector on a regional scale. In developing countries the

government is the main procurer of goods and services and, at times, competes with the private sector to the detriment of taxpayers and consumers who pay higher taxes in order to assist the government in acquiring goods and services that the private sector is able to provide efficiently. The consumers in turn are forced to consume at higher prices.

### **3.3.2 The principle of subsidiarity**

According to the Southern Africa Development Community Treaty (1992) subsidiarity simply means that regional institutions should be responsible only for those activities that are not more efficiently handled at the national level. In return, government must be selective and economical in creating regional organisations and initiatives. There are two main reasons to respect subsidiarity, that is, to avoid overloading already scarce regional administrative capacity and resources and to assure that there is sufficient commitment and trust so that the key regional agencies will be given the authority and the means to implement the regional programme. If these conditions are not respected the regional effort will lose credibility, and this in turn could mean the undermining of future integration efforts.

Regional organisations should develop their own well-functioning bureaucracy to manage day-to-day activities. The lack of a regional bureaucracy is more apparent in developing countries (in particular in respect of RIAs in Africa) and this may have adverse results during multilateral trade rounds where negotiators from the developing world are unable to obtain better concessions on technical matters (Schiff & Winters, 2003; Economic Commission for Africa, 2005; Fabricus, 2006:21). In Southern Africa, the Southern Africa Development Community Treaty (1992) does acknowledge the creation of self-functioning institutions under the principle of subsidiarity; one example being the SADC Developmental Finance Resource Centre (DFRC)

which was established for the purpose of coordinating the activities of the national developmental financial institutions so that these institutions may be geared towards accelerating the regional agenda by, for example, financing infrastructure through public-private partnership (PPP) programmes. This is controlled and managed by seconded members of the SADC development financial institutions (DFIs) such as the Development Bank of Southern Africa and other similar institutions in other SADC member countries, as these seconded members have the necessary expertise as opposed to the general bureaucrats at the SADC Secretariat.

### **3.3.3 Adherence to the principles of pragmatism and gradualism**

Fundamentally, accelerated integration means credible integration built on pragmatic, gradual steps that reinforce trust and commitment and render the process self-perpetuating. It serves no purpose for member states to focus on setting a shorter timeframe within which integration must be achieved without checking the development imbalances of each member state, for example, a least-developed member country such as Lesotho (in case of SACU) cannot be expected to reduce its tariff level within the same timeframe as South Africa (McCarthy, 1999: 390; Ajayi, 2005: 20). It makes more sense to set a realistic, longer timeframe than a shorter and unrealistic one. Even in the case of a developed region such as the EU, it took the member countries at least fifteen years to reach a common market<sup>19</sup>. It is certainly valuable to have a clear vision of what regional integration should ultimately mean in the region, but experience also strongly suggests that it would be wise to move forward in a pragmatic, gradual fashion by creating timetables and targets that are credible and realistic.

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<sup>19</sup> Since the signing of the Treaty of Rome in 1957 (establishing the European Economic Community), the common market was adopted in 1973.

When goals are not achieved, this can lead to missed targets, frustrations and disappointments, and, in the end, reversals. The challenge is posed by the very issue integration sought to address, namely, the diversity in almost every geographic, linguistic, political and economic challenges in member states. In this context, a strategy combining variable geometry (the sequencing of integration in geographic space, allowing subsets of countries to move faster and deeper in certain areas), and variable scope (seizing opportunities to advance integration in areas in which conditions are propitious) is probably the most appropriate and effective strategy for most of the subregions in SSA.

Gradualism provides low risk opportunities to build experience and mutual trust progressively, which are both essential for integration to move forward and deeper over time (Foroutan, 1993: 24). The discussion on the experience of regional economic integration in Africa in Chapter 4 and 5 will highlight some of the challenges resulting from hastily convened regional economic communities that have ambitious goals that are not commensurate with the level of the economic development in those regions.

One other important facet of pragmatism and gradualism is open access, which means that regional integration arrangements must remain open to new membership from the countries of the subregion. A core group of countries may join but they must create the opportunity for other neighbours to join if and when they meet certain criteria, such as the EU Convergence Criteria.<sup>20</sup> Although the process of building the African Economic Community may proceed through the amalgamation

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<sup>20</sup> The European Union (EU) Convergence Criteria has been discussed in detail in section 2.6.2.



of regional economic communities, ultimately, the entire continent will become a group of contiguous countries, providing a unified geographic base for the markets of goods and services (World Bank, 2000; Ajayi, 2005).

### **3.4 Gains from regional economic integration in the developing world**

Among other gains attributable to customs union membership, member countries have the potential to act collectively during multilateral trade negotiations and this increases their bargaining power. Their terms of trade may improve relative to other countries, for example, it has been estimated that the EU was able to increase its terms of trade by one per cent of gross national product (GNP<sup>21</sup>) after the formation of the customs union. The following are some of the gains that can be realised through the membership of RIA:

#### **3.4.1 RIA's impact on productivity within the region**

The mechanism of dynamic gain is provided by increased competition, which may in turn stimulate a higher level of efficiency. In a more competitive market less efficient producers (those producing at relatively higher costs) will be undercut and forced either to improve their production method or be driven out of business. After regional integration monopolies in domestic markets will be undermined by exposure to highly competitive imports. In order to stay in business, the monopoly pricing firm will have to compete effectively by altering its pricing policy. In order for competition to flourish there is a need for a regional competition policy to regulate the behaviour of companies. This

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<sup>21</sup> Gross national product (GNP) is the value of goods and services produced by the residents of the country and it is calculated on an annual basis.

regional policy will prevent any merger and acquisition between businesses that could leave the consumer worse-off as a result of the restriction in his/her choice of consumption due to an increase in price resulting from a monopoly's discriminatory pricing. The regional economic policy will prevent monopolies from more affluent countries from acquiring similar businesses from the less developed associates. For example, without the EU Competition Policy, conglomerates from France, Germany, Italy and the United Kingdom (UK) will find it easier to acquire smaller firms in the other 23 member countries even if such a move was detrimental to the consumers who normally suffer through monopoly pricing behaviour (Shams, 2005:6; Jansen & Vennes, 2006:20).

If productivity levels depend on the size of the market, then a widening market through RIAs would contribute to productivity growth, that is, RIAs would lead to an improvement in the dynamic efficiency of the economies participating in the union. The establishment of the above relationship (between market size and productivity) does not, however, imply that integration will necessarily be followed by a sustained increase in the rate of growth of productivity.

The transition years after integration will result in an increase in the productivity levels, but this may slow down in the long term, for example if, after integration, smaller numbers of firms merge to form a bigger firm with a bigger market share and this firm is a price-setter, then productivity might decrease as the monopoly might not produce according to market demands, but rather in order to gain a supernormal profit.

The gradual removal of capital controls by the South African government has led to an influx of capital (usually from South African

monopolies) to Southern African countries (SADC). South African monopolies, such as Telkom/Vodacom, have bought large blocks of shares in companies in the SADC and the resultant acquisitions have led to customers in the region being worse off than before as the new companies use South African pricing for customers in the region (Doing Business in Africa, 2006).

### **3.4.2 Attraction of foreign direct investment**

A sizeable region may attract foreign direct investment (FDI) both from within and beyond the regional economic community as a result of market enlargement and production rationalisation (reduced distortion and lower marginal cost in production). The formation of RIA encourage clustering of firms by increasing market size and allowing for more effective exploitation of the links between firms. An RIA may attract industry into member countries at the expense of non-members (although if the RIA is small such effects will also be very minimal). RIAs also frequently result in industries relocating from one member country to another (Doing Business in Africa, 2006; Kolala, 2000).

It would appear that RIAs between poor countries would be likely to increase inter-member inequalities because firms tend to agglomerate their productions in the more prosperous countries while still selling in the other member countries. For RIAs involving richer member countries the results are less clear-cut, and it is possible that poorer members could experience industrialisation as a result of joining an RIA. When the agglomeration effects are considered integration with richer neighbours (in a North-South RIA) look to be a far better option for developing countries than does South-South integration (Shams, 2005:6; Jansen & Vennes, 2006:20).

A large regional market is conducive to a higher level of both indigenous and inward investment, which is a key factor in raising the level of economic growth and economic development. The level of investment depends on the performance of the economy, for example, during economic expansion, investors flock to invest so that they are not left out, but, during a recession, investment diminishes as investors are not sure if they will realise the return on their investments. Within SADC the signing of the FTA protocol in 2000 and the removal of the majority of capital controls have resulted in massive investment by South African firms in the region.

The logic is that larger markets, more competition and improved policy credibility will increase the incentives for investment and so raise incomes. This argument is relevant to all investment but is applied most explicitly to foreign direct investment (FDI). Early RIAs were activist and interventionist, and co-opted regional integration into import substitution at a regional level. These policies failed comprehensively and have been superseded by a far more market-friendly approach that places greater emphasis on policies which guarantee the fair treatment of investment. These guarantees are often embodied in bilateral investment treaties (BITs) or in the investment chapters of RIA agreements. BITs typically contribute to investment by prohibiting certain policies rather than by requiring policies that actively encourage investment. However, they may play an important role in facilitating investment flows (McCarthy, 2004; Keck, 2004).

### **3.4.3 Regional economic integration arrangements as stepping stones to multilateral liberalisation**

In broad terms, the desire for closer regional integration is usually related to a broader desire for “opening to the outside world”. Regional economic cooperation is pursued as a means of promoting

development through greater efficiency, rather than as a way of disadvantaging others. The majority of members of these arrangements genuinely do hope that these regional economic integration arrangements will succeed as building blocks for progress with a growing range of partners and that they will open the way towards a generally more free and open global environment for trade and investment. However, regional arrangements will always be the 'second best' option. The chances of new bilateral or subregional arrangements contributing to, rather than undermining, the rules-based multilateral system, centred on the WTO, will depend both on the economic characteristics of the countries involved and on the details of the design of the new partnerships. If designed badly, regional arrangements will certainly be a stumbling block rather than a stepping-stone (Lawrence, 1995; Bhagwati & Krueger, 1995).

In Chapter 2, the argument was put forward that, even if RIAs are inferior to full liberalisation, they should nevertheless be viewed as a positive step in the direction of liberalisation as long as they are trade creating and welfare-maximising. According to this point of view, regional integration is perceived as establishing a path towards more complete global integration, and thus is likely to be beneficial in the long run (Summers, 1991). Most RIA protocols usually contain a clause indicating that such an agreement is a stepping stone towards multilateral liberalisation, for example, in the South African Custom Union (SACU Treaty, 2002).

RIAs are perceived as being easier to negotiate than full multilateral agreements because they involve fewer members, so that some level of integration may take place more quickly. Furthermore, the establishment of a RIA may be costly for non-members (if they are hurt by trade diversion), thus creating an incentive for the non-members to make an effort to join.

In this 'domino' effect the more non-members that eventually join, the closer the RIA comes to approximating world trade (as illustrated by the earlier bilateralism and regional agreement in the Cobden Treaty and the Zollverein agreement in the 19th Century) (Machlup, 1976; Balassa, 1961, Baldwin, 1994).

#### **3.4.4 Development of regional infrastructure**

The benefits of a well-developed infrastructure are crucial for improving the prospects for regional integration and enhancing regional identity (Matlosa, 2005). Region-wide transportation and communication networks are likely to be cheaper on a per unit basis. Larger markets may also be conducive to spill over effects such as the transfer of knowledge from producers to users. Mutual gains may be realised from the joint production of public goods of common interest. For example, member countries of SADC agree to cooperate in the construction of connecting roads or rail networks, or in the joint management of natural resources. SADC has identified 800 spatial development initiatives (SDIs) that are projected to cost US\$ 32.4 billion and generate more than 85000 new jobs. The following represent some of the SDIs planned for SADC (SADC Today, 2006):

- The Maputo Development Corridor, which links up to the Mozal aluminium smelter and iron and steel plant in Maputo and also connects Mozambique and South Africa via a toll highway. The project has attracted over US\$3 billion in intra and extra regional investments. At the time of writing, this project was almost complete
- The Lubombo SDI, which is regarded as one of the most important tourism developments in Africa. The governments of South Africa, Swaziland and Mozambique are the main players. It seeks to develop the trans-frontier park and the supporting

infrastructure between the three countries. In addition to private sector investment, the three governments will have to make commitment in terms of funding. On completion, it is envisaged that it will create employment for communities along the park and connect them through road infrastructure, enabling them to trade with ease.

- The Coast-to-Coast SDI, which seeks to link the nodes of Walvis Bay and Maputo. Other SDIs include the Beira Corridor, the Okavango and Upper Zambezi International Tourism Initiative, the West Coast Development Initiative and the Fish River SDI.
- The Westcor project, signed by Angola, Botswana, South Africa, Namibia, the Democratic Republic of Congo and Zambia on October 2004, aims to build a third hydro plant (Inga III) with 39 000 MW capacity on a tributary of the Congo river. Furthermore a new power line will be built connecting oil-rich Angola and Namibia. The project is estimated to cost about US\$ 80 billion. The feasibility studies have been concluded and it is envisaged that the hydropower station will be able to supply electricity to Southern Africa and beyond (Keck, 2004; SADC Report, 2006).

However the financial constraints facing developing countries make the realisation of some of the proposed projects impossible. Even in respect of SADC, the region depends on donor aid to fund its projects. The ability of the region to raise funds externally is hampered by the fact that most member states have a poor international rating and this impact on their ability to obtain credit from international financial institutions (IFI) such as the World Bank. There is a need for the RIAs to develop a regional development fund for infrastructure projects, but since this should be funded by member countries, some of which are very poor (a large proportion of their national budgets is supplemented by donor funding), this could be an insurmountable task. It must also be borne in mind that certain SADC member states cannot even afford to pay their

annual membership fees to the regional body. It is therefore important for the developing regions, in particular those in Africa, to maintain good macroeconomic fundamentals and political governance, as this may lead to good sovereign rating which is the one of the determining factors when seeking loans from international financial institutions and developmental banks (SADC Today, 2006; African Development Bank, 2007).

#### **3.4.5 Building a sense of security in the neighbourhood**

RIA creates a sense of security in the region as a result of interdependency among member state This is likely to build trust, raise the opportunity cost of war. For example, it has often been argued that democracies (countries that share the same value of governance regulated by democratic principles) never attack each other, and, thus far, history has borne this out. It would be difficult to imagine the members of the EU waging war on each other, since, as a result of economic linkages and dependency; they stand to lose too much. They also have mechanisms in place to resolve disputes. This is also the case in the United States where the proposed Free Trade Area of the Americas (FTAA) is linked explicitly to the promotion of democracy as well as to economic development. East Asian economies are also searching for ways to bring about closer cooperation in terms of security as well in economic matters (Inotai, 1986; Lawrence, 1995; Matlosa, 2005:5).

It is also possible that RIAs could create tensions among member countries should the existence of the RIA result in more divergence than convergence by accelerating the trend of concentration of industry in one or more countries. For example, the East Africa Community (EAC) was disbanded in 1977 as Tanzania and Uganda viewed it as a vehicle for Kenya to promote its own economic interest by dominating



their economies and, furthermore, there was no compensatory mechanism for trade diversion for the lesser developed members, namely Tanzania and Uganda. On the other hand, RIAs may actually improve intra-regional security by developing a culture of cooperation and mechanisms to address issues of common interest. Cooperation may even extend to common defence or mutual military assistance such as the Organ for Politics, Defence and Security of SADC, which is a conflict resolution mechanism in the region (Matlosa, 2005:6).

### **3.4.6 Management of trade friction**

The management of trade frictions is another motivation for the formation of regional integration arrangements. This was part of the underlying rationale for the formation of the Asia Pacific Economic Community (APEC),<sup>22</sup> which offered an opportunity for trade and investment policy dialogue (also between Japan and the United States of America) at a time when trade frictions in the Pacific risked impacting negatively on other regional economies. The danger is that bilateral and sub-regional deals could lead to the proliferation of non-transparent, non-WTO consistent mechanisms for the management of bilateral trade (Ariff, 2006).

Certain countries are of the opinion that being part of preferential arrangements is a possible means of avoiding exposure to safeguard measures. For example, the fact that Australia is currently seeking an FTA with the United States explains the fact that Australia is not joining other affected countries in protesting to the WTO about recent US safeguard duties on steel. This is, however, a two-edged sword, in that

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<sup>22</sup> APEC is a 20-member RIA comprising Asian as well as Pacific countries. The US and Japan are the leading nations of the group. The aim of the group is to reduce tariffs and other trade barriers between member countries whilst opening up to trade with the rest of the world.

resorting to special bilateral and regional arrangements could preclude recourse to the rules of the WTO. At the same time signing away these hard-won rights in the WTO could contribute to a breakdown in the WTO system (General Agreement on Trade and Tariffs, 1993; Wilson *et al*, 2004).

### **3.4.7 Solidarity during multilateral trade talks**

The solidarity of developing countries as a region or as a group during multilateral trade negotiations has given them an upper hand when they negotiate trade issues in WTO round talks. The Doha Developmental Round has shown that solidarity on specific issues in which countries have an interest (for example, the reduction of the agricultural subsidy by the EU and the US, which is an area in which the majority of developing countries have a comparative advantage) may result in sufficient pressure to compel the developed world to succumb. The G20 and G90 (groups of developing countries) solidarity harnesses their intellectual capacity in technical issues in trade talks that an individual country is unlikely to provide (Mbekeani, 2002, Ajayi, 2005; Matlosa, 2005).

On the regional level, solidarity increases the chances of developing countries to obtain favourable concessions when negotiating with the developed world, for example, the united front presented by members of the SADC in their negotiations with the EU over Economic Partnership Agreements (EPAs) could have been impossible if each country had been negotiating on its own with the EU. On the other hand, the presence of bigger player(s) within the RIA that demonstrates an ability to lead may contribute to the success of the North-South trade talks. In Southern Africa the presence of South Africa in both the SADC and the SACU enables the two groups to achieve better concessions when engaging with any other regional group/country in a trade issues. In the absence of this solidarity, the developing countries would simply

rubberstamp the decision of the developed world even though it is to their disadvantage (World Bank, 1994; Pearson, 2004).

### **3.5 The costs of regional economic integration**

#### **3.5.1 Overlapping membership in regional economic communities**

The constraints of overlapping membership in regional economic communities may be classified as an impediment to successful regional economic integration. This is more apparent in the RIAs of developing regions than developed regions. According to McCarthy (1999: 374) and Shams (2005: 4) RIAs in developing regions are constrained by the problem of overlapping membership, where a country is a member of more than one RIA, each with different objectives. Member countries from developing RIAs, such as those in Sub-Saharan Africa, join different regional economic communities in the hopes that they will derive more economic benefits. As a result of the fact that the RIAs may differ in terms of agenda and end goals, developing countries will then be caught up in a scenario that requires them to implement different policies with conflicting agendas. More resources (human, money and time) than necessary will be utilised to serve these different interests which will have arisen as a result of their membership of more than one regional economic community.

Overlapping membership in different regional economic communities is no more apparent than in the Sub-Saharan RECs. For example, the future shape and speed of regional integration within sub-Saharan Africa will be determined by a combination of internal and external factors. Internally SADC and the Common Market for Eastern and Southern Africa (COMESA) have expressed their intention to establish customs unions by 2008 and 2010 respectively.

Countries that are members of more than one such arrangement would be required to choose between these arrangements as it would be impractical to claim membership of different customs unions, for example, if a country were a member of two custom unions, the problem would arise as to which common external tariff (CET) the country will implement, taking into consideration that common external tariffs are at different levels for different customs unions (Pearson, 2004; Economic Commission for Africa, 2005; Musila, 2005).

In addition, the five SACU member countries have recently signed a new agreement (in 2002) which broadens the scope and decision-making practices of the existing arrangement. Externally, a range of new trade agreements threaten to drive a wedge between the Southern and Eastern African states. For example, SACU has commenced negotiations with the United States (US) on an extensive FTA. Discussions with MERCUSOR are also underway and South Africa has expressed a willingness to lead SACU into bilateral trade agreements with Nigeria, China and India. These agreements will help to cement SACU as a regional block, but will make it more difficult for its members to participate in other regional trade arrangements (as a customs union) because of conflicting agendas (McCarthy, 2004, Pearson, 2006).

### **3.5.2 Polarisation effects in regional economic agreements of developing regions**

McCarthy (1994) stresses that industries in RIAs tend to cluster in locations with relatively good market access, or in locations that are well supplied with business services or the provision of other intermediate goods. This is more likely to occur in developing countries than in developed countries, partly because of the sparser provision of business infrastructure in developing countries, and partly because the small size of their manufacturing sectors means that clustering is less

likely to run into congestion and other sources of diminishing returns. The clustering may lead to wages being increased in one member country at the expense of others. Given that Sub-Saharan Africa has a high level of asymmetry in development, the polarisation effect would affect all RIAs in the subregion. In Southern Africa businesses tend to move south, in particular to Johannesburg and the other major urban centres in South Africa. The reason for this movement may be attributed to the fact that the RSA is more developed than other Southern African countries and has a wealthy population which consumes goods and service at a higher rate than in other countries in the region. This is one of the justifications used by other members of SACU to demand more compensation for being locked in a customs union with South Africa.

Prior to 1994, the relative isolation of South Africa and the pressure on international companies to withdraw from the country could have provided opportunities to attract investment to the then BLS states. Furthermore, these countries made very little use of Article 6 (infant industry protection) and Article 7 (protection of industries of major importance). South Africa used the tariff structure and subsidies to prevent new industries in the BLS states<sup>23</sup> from competing successfully with its own industries. In addition, decentralisation incentives provided by South Africa to channel investment to the homelands<sup>24</sup> in South Africa certainly diverted investment from the BLS countries. These incentive schemes clearly indicate that, with a stronger political will on the part of South Africa, the objective stated in the preamble to encourage development in the less advanced countries could have been pursued. Thus, instead of compensation, money could have been made available for specific programmes to improve the investment

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<sup>23</sup> Namibia was not independent at that time.

<sup>24</sup> The homeland system in South Africa included the 'four republics' of Transkei, Bophuthatswana, Venda and Ciskei as well as the 'governing territories' of Lebowa, Kangwane, Kwandebele, Kwazulu and Qwaqwa.

climate in the BLNS states (Southern African Customs Union Treaty, 2002; McCarthy, 2004).

There has been a renewed thrust in recent years toward broader and deeper preferential trade arrangements in Africa on both continental and regional levels. Southern Africa faces a difficulty inherent in the composition of the region: The relatively developed economy of the Republic of South Africa and its dominance of the regional market could result in economic polarisation within the region, while the pace of economic reforms within South Africa could either accelerate or delay regional integration initiatives. Furthermore polarisation may also be observed within member states, as certain regions are more developed than others. For example, South Africa, despite its status as the economic powerhouse on the continent, has a problem with inequality within its provinces, where the standard of living of people in poor rural areas is similar to that of other African countries, whereas the wealth in metropolitan areas is comparable to that of the developed world (McCarthy, 1994; Abdoulai, 2005; Shams, 2005).

There is a need for counter-balancing or countervailing mechanisms to accommodate regional objectives such as balanced development, but not one of the predominant countries is sufficiently wealthy to consider introducing outright compensatory mechanisms. Furthermore, there could possibly be the incentive for South Africa, and, implicitly SACU, to strengthen economic relations and cooperation with developed countries and markets rather than engage in South-South regional cooperation with the countries in the region and their intractable internal problems (Masson and Pattillo, 2005; Piazzollo, 2002).

The question arises as to how a regional integration strategy could accommodate the disparate levels of development in Southern Africa,

as, from South Africa's perspective, these disparate levels mean that any regional integration strategy would resemble more a North-South relation. In Latin America (in particular within MERCUSOR<sup>25</sup>) Brazil occupies the pole position such as that of South Africa within SADC region. It is important for the leading nations within a REC to provide leadership positions to countries in the region and to avoid using the lesser developed members as consumption outposts where companies from the wealthier member countries establish retail and other business which are managed by expatriates and do not contribute to the development of the country in which they are operating (McCarthy, 1994; Schiff, 2002; Schiff & Winter, 2003).

### **3.5.3 Regional trade dependency**

Masson and Pattillo (2005) and McCarthy (2004) emphasised that regionalism encourages dependency between countries in the region, especially in respect of those countries in which the import-export ratio of GNP is higher. For example, in SACU there is an obvious dependency of smaller economies (such as Lesotho and Swaziland) on South Africa, since 80 per cent of their trade is with South Africa. At the same time South Africa's trade with other SACU members is less than 5 per cent of its total trade. In NAFTA the USA absorbs 81 per cent of Mexico's exports and provides 80 per cent of Mexico's imports. With the US, however, Mexico receives seven per cent only of the total exports of the USA and provides only six per cent of the total import to USA.

The problem of asymmetrical trade flow affects all regional economic communities. Even in the case of a developed RIA, such as the EU, trade flow to the Eastern and Southern members became such a

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<sup>25</sup> MERCUSOR is the Southern Common Market that comprises Brazil, Argentina, Paraguay and Uruguay.

contentious issue during the accession negotiations that it had to be discussed at European Summit level. The accession of twelve former communist block countries into the EU in 2004 brought about several challenges which were manifested in the asymmetry of trade flows. For example, the industrial products from the new entrants despite being competitive (in terms of price) as compared to those of EU core members such as Germany and England, could be overlooked by the consumer who is still of the opinion that products from the former Communist block are inferior to those of core EU members (European Commission Report, 2005).

In order to address the problem of dependency and trade asymmetry, RIAs must contain institutional stipulations that are aimed at developing the economies of the poorer regions; the European Development Fund/Structural Fund oversees the development of poor regions. SACU, despite having a developmental goal as its objective (SACU Treaty, 2002), has thus far not been able to assist poor members with their economic development.

The problem confronting SACU is that one dominant economy (South Africa) cannot meet the challenges of economic development faced by its neighbours without jeopardising its own developmental goals. There are, however, development financial institutions such as the Industrial Development Corporation (IDC)<sup>26</sup> and the Development Bank of Southern Africa (DBSA) that promotes investment in the region. These two institutions work on a profit basis, and as such, will not attempt to invest where profits will not be realised.

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<sup>26</sup> Both IDC and DBSA are owned by the South African government and, despite the clause that stipulates that these institutions have an autonomy in the way in which investment decisions are made; the government still implicitly make decisions (through its appointed board) on projects to be financed on a continental or regional scale. These institutions prioritise the poor regions of South Africa over the SADC or any other continental projects.



### 3.5.4 Trade deflection

According to McCarthy (1994) and Krugman (1984) trade deflection refers to a situation in which a country not in receipt of preferences essentially circumvents the MFN tariff of a preference donor by transshipping its exports through a country which is in receipt of preferences, adding little or no value in the recipient. This occurs when a non-member country circumvents the higher tariffs that exist between itself and the country to which it intends to exports goods by means of an FTA. In order to prevent trade deflection Rules of Origin (RoO)<sup>27</sup> are set between member countries to ascertain the value-added for all intraregional imports. The other function of RoO is to foster industrial development within member countries of the regional economic integration arrangement. RoO are however costly to manage as more resources will be directed to the ports of entry to administer them.

As soon as an FTA is declared a customs union, all RoO cease to apply. RoO are used to foster economic development in terms of building new industries that are able to supply the captive market with a choice of capital goods that are normally imported from the developed world. In most developing customs unions there exist situations in which a non-member country will build an assembly factory within a member country that produces capital goods in terms of which there is little value-added locally. For example, South Africa lodged a complaint as a result of the Volvo company operating an assembly plant in Botswana as way of circumventing the Rules of Origin that are applicable to trade between South Africa and Sweden, where Volvo has its headquarters taking advantage of SACU (which does not have RoO), in which Botswana is a member.

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<sup>27</sup> RoO are laws, regulations and administrative practices used to identify the country of origin of internationally traded goods.

### **3.6 Implications for the multilateral trade regime**

The negotiation of inconsistent, non-transparent and overlapping sets of regional/bilateral rules outside the WTO system ultimately adds to the costs of doing business. It leads to commercial confusion as to which rules apply in which markets and under which circumstances. The greater the number of new arrangements that are put into place, the more complex the tangled web of new rules becomes. Unfortunately obtaining consensus from the regional partners about the new rules is also often very difficult, time consuming and expensive administratively. FTAs, in particular, rely on the enforcement of rules of origin, and these are becoming increasingly difficult to administer, since globalisation and intra-industry trade are making it more difficult to establish the source of products (Schiff, 2002; World Bank, 2005b).

If all the regional trade agreements which have been negotiated to date had been implemented fully, the WTO Secretariat estimates that as much as half of world trade would be tied up in new discriminatory rules and this would obviously impede world trade. This represents a tremendous leakage from world trade, with significant negative consequence for its rate of growth. It is ultimately not possible to have it both ways. If governments want multilateral trading systems that work to maximise world trade, then regional economic communities must be designed in such a way that they do not undermine the system.

The negotiation of new regional and bilateral trading arrangements will consume significant policymaking and scarce trade negotiating resources, some of which will inevitably be diverted from the Doha Developmental Round which is currently at an impasse after six years of negotiations. This could lead to a slowdown in the negotiating process in Geneva and a problem in terms of the timetable agreed for completion of the Round. This would mean a delay in the delivery of the

much bigger economic gains available from global rather than from regional trade liberalisation. It is important to recall that, while pursuing regional/bilateral trade negotiations, liberalisation of trade within the WTO context could lead to gains which would dwarf those available among smaller subsets of countries under regional economic communities (Irwin, 1993; Schiff & Winters, 2003; Fabricus, 2006:21).

### **3.7 Conclusion**

The assessment of regional economic integration has revealed that there is a difference between the instruments used for measuring success in the developed and the developing regions. In developed economies the success of an RIA is evaluated in terms of growth in per capita income, economic growth for member countries, the level of intra-regional trade and specialisation in the efficient production of goods and services. In addition to the measurement criteria listed above, the developing world judges the success of an RIA on economic development which is measurable in terms of infrastructure development and the reduction of poverty among the population. The difference in the measuring criteria may be attributed to the dissimilar levels of development that characterised each region. In the developed world, economic development and industrialisation were pursued before the regional economic integration undertaking by member states.

In order for the regional economic community to be successful it must be open to new membership and to multilateralism, and abide by the principle of subsidiarity in terms of which the state and non-state actors share the responsibilities of regional economic integration according to their relative strengths. This is done in order to avoid overloading already scarce regional administrative capacity and resources, and to ensure that there is sufficient commitment and trust so that the key regional agencies will be given the authority and the means to

implement the regional programme. Furthermore, regional economic integration should be gradual, and member states must avoid setting timeframes that are not feasible, as failure to adhere to these timeframes could reduce the credibility of the integration project.

Developing regions, like their counterparts in developed regions, stand to gain from regional economic integration if there is adherence to the principles of successful regional integration (described in this chapter). Gains that may be made include, among others, the opportunity for regional and international investments, and bargaining power during multilateral trade negotiations. At the same time the RIA may be hampered by overlapping membership in different regional economic communities, it could increase trade dependency on larger member states, and it could also slow down progress towards global free trade as a result of member states expending time, money and human resources negotiating the regional integration arrangements instead of multilateral trade rounds through the World Trade Organisation.

## CHAPTER 4

### REGIONAL INTEGRATION EXPERIENCES

#### 4.1 Introduction

The early success of the European Economic Community (EEC) (subsequently the European Union) demonstrated the way in which regional economic integration may lead to the improvement of the welfare of the citizens in member states. This prompted many developing countries to seek similar gains within their own regions. Certain RIAs are purely South-South integration, for instance, the Southern Africa Development Community (SADC) which is between developing and least-developed countries. There is also North-South integration in terms of which both industrial and developing countries are members, for example, Asia-Pacific Economic Cooperation (APEC), which is a forum for 21 Pacific Rim countries or regions to discuss the regional economy, cooperation, trade and investment. APEC comprises United State, Japan, Canada, Australia and New Zealand and the countries occupying the geographical space of Pacific and South-East Asia. Still others are North-North agreements, that is, a union between industrial countries, for example, the EU (Coe & Hoffmaister, 1998; Dick, 2002; Shams, 2005: 6).

Although the focus of this chapter is regional economic integration in the developing world, the chapter will also include EU integration as many RIA arrangements in developing countries benchmark themselves on the developments of the EU. Another case study will be the North Atlantic Free Trade Agreement (NAFTA) which is an agreement between two developed countries, Canada and the United States, and a developing country, Mexico. NAFTA will be discussed to highlight the potential gains resulting from economic agreement between developed and developing countries (North and South). The

Southern Africa Customs Union (SACU) represents the success of regional integration between developing countries.

The chapter is divided into six sections. Section 4.2 will include the case studies on the EU and NAFTA integration processes; Section 4.3 will highlight regional integration experiences in developing regions with the exception of Africa, which will be discussed in Section 4.4; in Section 4.5 the economic and developmental effects of African economic integration will be discussed:

Section 4.6 advances the lesson EU integration holds for the developing regions and in Section 4.7 suggestions will be made regarding the ways in which Africa may extricate itself from under-development and attain maximum benefits from the regional economic integration process. The conclusion will then follow.

## **4.2 Regional integration in the developed world**

Although there are many regional economic communities in the developed world, the EU integration will be used as the benchmark for full integration as the EU has progressed through almost all the stages of linear integration (just short of a political union). Despite differences that exist in the stages of industrialisation and economic development, developing regions have simply replicated the EU integration model, with the aim of reaching full integration in a short space of time. The case study on the North Atlantic Free Trade Agreement (NAFTA) will highlight the experiences of North-South integration between Canada and the US (North) and Mexico (South).

#### 4.2.1 Case study I: The EU economic integration process

The EU is a supranational and intergovernmental union of nation-states in Europe. It was established in 1992 by the Maastricht Treaty, and is the successor to the six-member EEC,<sup>28</sup> which was founded in 1957. As of 2007 new accessions have increased membership of the EU to 27 member states, and its competences and goals have expanded. The EU is the result of a continuing process of European integration (for almost fifty years) of which the end state has not been defined<sup>29</sup> (Salvatore, 1990; Baldwin 1994; European Commission Report, 2005).

The EU is now the largest political and economic entity on the European continent, comprising approximately 493 million people and an estimated GDP of €10.5 trillion, which is second only to that of the US.<sup>30</sup> The EU is a customs union and a single market with a common trade policy. It has its own currency, the Euro, which has already been adopted by 13 member states. The EU has a Common Agricultural Policy,<sup>31</sup> a Common Fisheries Policy and a Regional Policy to assist poorer regions. It has initiated a Common Foreign and Security Policy, and a limited joint policy on crime. The services sector is by far the most important sector in the EU, comprising 69.4 per cent of GDP, compared

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<sup>28</sup> The inaugural members of the EU economic community were Belgium, France, Germany, Lichtenstein, Luxembourg and the Netherlands.

<sup>29</sup> There is no agreement among EU members with regard to what constitutes a desirable end state. For certain members the EU has reached its final integration stages as an economic union whilst others believe that it should be allowed to graduate into a political union.

<sup>30</sup> The US gross domestic product (GDP) is currently 12.4 trillion US dollars.

<sup>31</sup> The agricultural sector is supported by subsidies from the EU in the form of the Common Agricultural Policy (CAP). This currently represents 40-50 per cent of the total spending of the EU. It guarantees a minimum price for farmers within the EU. This has been criticised as a form of protectionism, inhibiting trade, and damaging developing countries – one of the most vocal opponents is the United Kingdom which is the second largest economy in the block, but whose agriculture composition is minimal. The UK complaint lies in the management of rebates which it says are unjustified.

to the manufacturing industry at 28.4 per cent of GDP and agriculture at only 2.3 per cent of GDP (Salvatore, 1994; European Commission Report, 2005).

Important EU institutions and bodies include the European Commission, which manages the day-to-day activities of the Union, the Council of the European Union, which is the executive arm of the Union, the European Central Bank, which is the custodian of monetary policy within the Union, the European Court of Justice, which is the arbiter of disputes between EU member states, and the European Parliament, which is the legislative body on EU affairs. Once every five years, EU citizens elect the European Parliament directly.

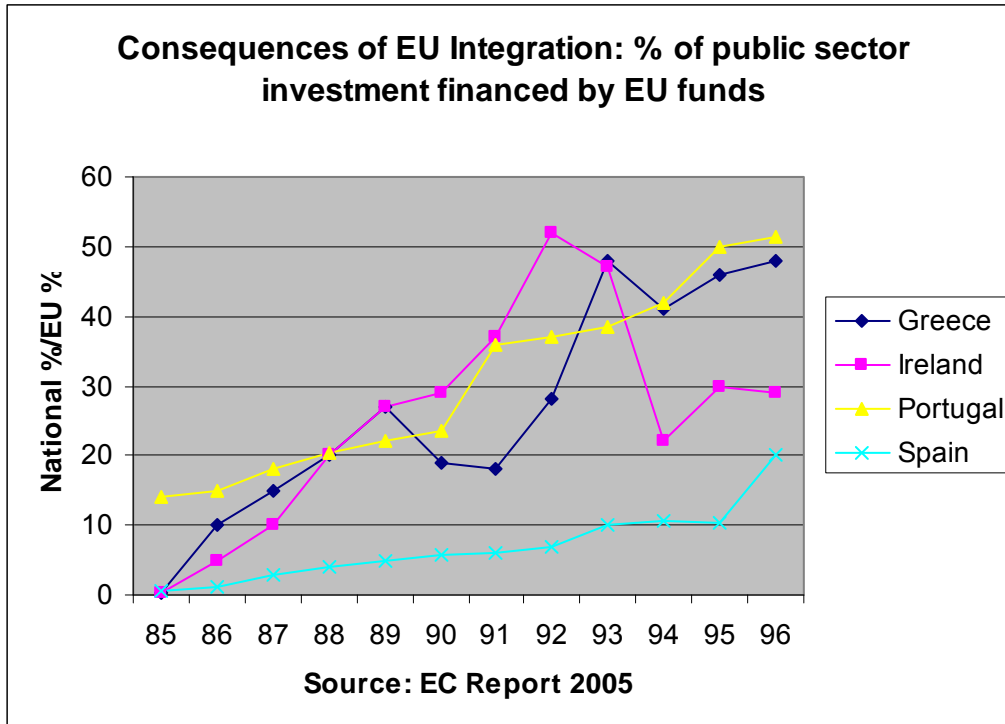
Each member country is represented within each of the above-mentioned EU structures. Economic performance varies from state to state. The Growth and Stability Pact governs fiscal policy within the EU. It applies to all member states with specific rules which apply to the Euro zone members that stipulate that the budget deficit of each state must not exceed 3 per cent of GDP and its public debt must not exceed 60 per cent of GDP. The EU is the largest exporter in the world and the second largest importer (after the US). Intra-regional trade is about 60 per cent of its total trade and tariffs are almost non-existent (Baldwin, 1994; Pelkmans & Brenton, 1999; European Central Bank Convergence Report, 2004).

#### **4.2.1.1 The benefits of EU economic integration**

Regional economic integration in the EU has generated different patterns of convergence and growth. Ireland, Greece, Portugal and Spain have benefited from integration in the EU and may now be considered as developed countries, having formerly, on accession in



1974, 1981 and 1986 (for both Portugal and Spain) respectively, been amongst the poorer countries of Europe.



**Fig 4.1: Public sector investment by EU Development Fund, Source: European Commission Report 2005**

According to Viner (1950), Meade (1955), Salvatore (1990) and Baldwin (1994) the major benefits from entry into the EU are: (1) increase in trade and capital flows; (2) improvements in hard and soft infrastructure as a result of the structural funds given to member states<sup>32</sup>; (3) reduced

<sup>32</sup> Aid accounted for: 1, 5% of GDP in Spain and 3, 3% of GDP in Portugal. Public sector investment by EU Funds: over 15% was spent in Spain and 42% in Portugal. During the period under review, Portugal had the highest burden on EU fiscus earmarked for public sector investments.

the risk for business by fostering macroeconomic, legal and political stability; (4) the improvement in the welfare of citizenry, demonstrated by the convergence of GDP per Capita of poorer members to that of richer member states; (5) use of efficient methods of production by the integration of new technologies, of which the cost is partially subsidised by the EU; and (6) reduction of prices of goods as a result of the existence of a free market.

Figure 4.1 depicts the public sector investment financed by the EU Developmental and Structural Fund between in the period 1986-1996. Portugal as the poorest of the four countries received the major share of EU funds, followed by Greece, Ireland and then Spain. The funds transferred to poorer EU members are used to assist in infrastructure development and public expenditure so that the recipients' do not lag behind the wealthier countries in terms of development.

The European Central Bank Convergence Report (2004) refers to welfare increase as an important benefit of EU membership. An economic analysis carried out in Eastern European countries has shown that a welfare increase of 3.8 to 7.3 per cent may be expected for countries entering the EU. At the same time Baldwin (1995) highlights trade liberalisation as a definite benefit of EU membership. Since cuts in trade and agricultural tariffs occur in accordance with European Agreements, real trade costs decrease.

At the macroeconomic level the EU enlargement is expected to have an impact on the growth rate of the EU GDP. This is linked to the faster growth of consumer incomes and purchasing power (owing to changes in population structure and preferences) and will, in turn, enhance market opportunities.

**Table 4.1: The convergence of GDP per capita for Spain and Portugal on EU average**

	1985	1990	2000	2004
EU Total	100%	100%	100%	100%
Spain	72,5	77,8	84,4	98,0
Portugal	52,0	55,7	74,4	73,0

Source: European Central Bank Convergence Report 2004

With regard to the GDP per capita, as depicted in Table 4.1, indications are that the GDP per capita for Spain and Portugal are converging on the EU average. An analysis carried out over an eight year period (1985-2004)<sup>33</sup> has shown that Spain per capita GDP has increased from 72, 5 % of EU average in 1985 to 98% in 2004. With regard to Portugal, although there is gap between its per capita GDP to that of EU, there are signs of improvement as Portugal per capita GDP has expanded 30% towards the EU average during the review period. This has been made possible by an increase in productivity and investment from the other EU members contributing to employment which is positively correlated to the demands of goods and services in both economies (European Central Bank Convergence Report, 2004).

#### **4.2.1.2 The costs of EU economic integration**

Entrance to the EU is not without costs for new member countries. Pelkmans and Brenton (1999) mention the adoption of all EU norms and standards by enterprises, and threats to the market position of domestic producers as the most serious costs for countries entering the

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<sup>33</sup> The period 1985-2004 has been chosen as this period represents the entry and transition of Portugal and Spain into the EU.

EU. Another cost refers to the reduced autonomy in the decision-making process, which is an important factor in view of the different backgrounds and needs of countries. The transition costs may be very high and costly for countries with weak economies and environments. In view of the fact that a free market zone drives down prices on goods, the producer surplus of new members, such as Poland and Romania, will decrease significantly due to low prices.

In addition, poorer members, notably the twelve new member states, will need to import new equipment and technologies from wealthier members such as Germany and France. This extra cost may lead to a decrease in the producer surplus. Many of the European countries are not concerned with accession costs since membership is largely a political decision. In other words, countries deciding to join the EU take into consideration mostly the security benefits if their political situations are particularly grave.

#### **4.2.2 Case study II: The North Atlantic Free Trade Agreement**

The North Atlantic Free Trade Agreement (NAFTA) was formed in 1994 and is a free trade area between Canada, Mexico and the United States. NAFTA resulted in tremendous changes in both the economy and socio-political system of Mexico and, at the same time, opened the Mexican market for goods from the US and Canada. NAFTA has a lower degree of formal institutional cooperation than the EU (Baldwin, 1994).

The arrangement has been beneficial to Mexico for various reasons, including the adoption of a strengthened policy framework in the 1990s that has complemented the ability of the authorities to lock in major

domestic economic reforms. Increased cross-border trade flows have contributed to a greater synchronisation of the business cycles of Mexico with those of the US and Canada. In the financial sector, the significant share of the Mexican banking system owned by US banks has contributed to closer financial linkages.<sup>34</sup> As trade, economic and financial interdependencies have intensified the need to strengthen cooperative institutional arrangements might also arise at some point in the future (Frankel *et al*, 1995).

The impact has been both positive and negative: First, NAFTA has contributed to the transformation of Mexico into one of the major traders and the eighth leading exporter in the world. NAFTA has allowed Mexico to diversify its production and reduce its dependence on oil, which now constitutes less than 7 per cent of its total exports – down from 22 per cent in 1993. Secondly, NAFTA has provided Mexico with an attractive environment for foreign investors. Thirdly, NAFTA enhanced international crisis cooperation by paving the way for prompt US assistance to Mexico when the country experienced a financial crisis towards the end of 1994 (Dick, 2002; Guha-Khasnabis, 2004; World Bank, 2005a)

NAFTA has strengthened deregulation and transparency in policymaking by Mexico. On the other hand, Mexico's socio-economic situation has shown little real improvement. The burden of adjustment to NAFTA was much greater for Mexico than for the US because the economy of the US is much larger than that of Mexico. Under NAFTA there has been trade expansion of the inter-industry type based on differences in factor endowments.

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<sup>34</sup> Companies took advantage of the synergies created by NAFTA, such as in the case of ICA-Reichmann, a joint venture between a major Mexican construction firm and the renowned Canadian developer, and also Cifra-Wal-Mart, Cuauhtemoc-Moctezuma brewery and Canada's John Labatt, and tobacco giants Philip Morris and Cigata.

#### **4.2.2.1 The costs of NAFTA integration**

The continuous re-adjustments in the manufacturing sector produced an increase in unemployment of unskilled workers who were then absorbed by the informal employment sector. This, in turn, has adversely affected the accuracy of employment and job statistics. It is not clear whether increased FDI has contributed to an improvement in labour quality or not. Secondly, the gap between rich and poor has widened, and this has provided critical momentum to increased socio-political instability, which is an ever-present risk in Mexico. Thirdly, Mexico's economic success now tends to depend more than ever on US capital, and its economy has become more vulnerable to external shocks (Dick, 2002; Guha-Khasnobis, 2004).

The timing of the establishment of NAFTA overlapped with the ongoing unilateral trade liberalisation in Mexico and the sharp devaluation of the Mexican peso amid the financial crisis which lasted from the mid 1980s to the 1990s. This further complicates the possibility of offering an objective evaluation of the effects of NAFTA on Mexico. Although NAFTA proponents speak of the increase in exports, the FDI influx, productivity gains, and job creation as positive benefits arising from NAFTA, many of these have also largely resulted from Mexico-led reforms in trade liberalisation and the devaluation of the peso (World Bank, 1994).

On the other hand, although NAFTA opponents argue the negative effects of NAFTA, such as job losses and company bankruptcies in the manufacturing sector, increased vulnerability and socio-political instability, most of these had also occurred prior to the implementation of NAFTA, or would have occurred even without NAFTA under the ongoing liberalisation and globalised environment. Both the positive and negative evaluations of NAFTA tend to be exaggerated due to the

politicisation of the NAFTA analysis and also because of the practical difficulty in distinguishing the effects of NAFTA from those induced by other initiatives undertaken by Mexico herself.

The analysis of NAFTA integration allows one to extract lessons in respect of similar experiments in future North-South economic integration, for example, the Economic Partnership Agreements (EPAs) between the EU and the African, Caribbean and Pacific (ACP) regions completed in December 2007. It suffices to say that, without domestic commitment to policy reform, regional economic integration schemes, whether North-South or South-South will not result in an increase in the economic welfare of member states (Coe & Hoefmaister, 1995; Pearson, 2004 & 2006).

#### **4.3 Regional economic integration in the developing world**

In this section regional economic integration in developing regions<sup>35</sup> will be discussed, with as starting point the case study on regional economic integration within the Southern Africa Customs Union (SACU) arrangement, which is an arrangement which is regarded as the only functional and successful regional economic community in Africa. Together with developments leading to the formation of a customs union in SADC, SACU is seen as the nucleus of the new customs union in the region.

In Latin America, the Southern Common Market (MERCUSOR) will be analysed to establish whether there are economic gains which may be attributed to such integration. The development of South East Asia will

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<sup>35</sup> The developing regions will be represented by the regional economic integration experiments in Africa, Latin America and Asia.

represent regional economic integration in Asia. More attention will be concentrated on regional economic integration in Africa and an analysis will be carried out of the cost and the benefits of an RIA as measured in developing regions, that is, in terms of economic developments such as investment in public goods, infrastructure development and a reduction in poverty.

A key argument in favour of economic integration amongst developing countries is that it contributes towards gradual structural change and economic development. In addition, a larger regional market brings economies of scale that should enable member countries to specialise and to develop sufficient productive capacity to compete globally.

#### **4.3.1 Case study III: The Southern African Customs Union**

The study on the Southern African Customs Union (SACU) will focus on its structure, successes and challenges. SACU, comprising Botswana, Lesotho, Namibia, Swaziland (BLNS) and South Africa, is the oldest functional customs union in the world. It has been in existence since 1910. SACU was established through a customs union agreement between the Union of South Africa<sup>36</sup> and the three British administered territories<sup>37</sup> of Botswana, Lesotho and Swaziland. The 1910 agreement was replaced by the 1969 agreement and subsequently by the 2002 SACU agreement. SACU is the richest regional integration scheme in sub-Saharan Africa with a per capita income of US\$ 2 414. All SACU

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<sup>36</sup> The Union of South Africa comprised four provinces, namely Transvaal, Orange Free State, Natal and Cape. It was dissolved in 1961 when South Africa received its independence from the United Kingdom (UK).

<sup>37</sup> In 1910, Namibia (then South West Africa) was a German colony and was excluded from the original SACU Agreement. It was, however, incorporated into the SACU agreement in 1948, when the United Nations handed South West Africa over to the Union of South Africa, in appreciation for South Africa's support to the Allied Forces during World War II (1938-1945).



member states are members of SADC, while Swaziland is a member of both SADC and COMESA (McCarthy, 2004; SADC Today, 2006).

According to SADC Today (2006), SACU is recognised by the WTO and has already, in 2003, undertaken a trade policy review of the grouping. SACU has successfully negotiated trade agreements with the EU, the European Free Trade Area (EFTA), and SADC. Negotiations with the US, India and China will lead to another agreement (Fabricius, 2006).

#### **4.3.1.1 Economic policy and industrial development in SACU**

South Africa dwarfs the other four members economically. Imports amounted to over 90 per cent of the GDP in Lesotho, about 75 per cent of GDP in Swaziland, 36 per cent in Namibia and 16 per cent in Botswana for 2007. On average, South Africa provides 85 per cent of the imports for Lesotho, Namibia and Swaziland. The direction of BLNS exports is quite different from the source of its imports as the major destinations for BLNS exports are the EU, Asia and the US. This development may be explained in terms of the fact that the basket of goods exported are mainly, primary goods, which South Africa itself produces in abundance, and hence the low volume of exports to South Africa (Masson & Pattillo, 2005; Bertelsmann & Draper, 2006; Economic Research Bureau, 2007).

According to McCarthy (2004) the 1969 agreement sought to address the problems of economic underdevelopment and lack of industrialisation in the BLNS countries. At the time, the rationale for SACU integration was for fiscal compensation through revenue-sharing mechanisms, but it failed to address the causes of unequal development within the subregion (McCarthy, 1994). As a result there

has been little industrialisation within the BLNS and South Africa continues to record large trade surpluses with all other member countries. This lack of industrialisation and economic development in the BLNS may also be attributed to the effects of polarisation in favour of South Africa. The pursuit of an import-substitution trade policy by South Africa almost certainly resulted in significant trade diversion for the BLNS. It was therefore rational for the BLNS to focus on efforts to maximise the revenue-sharing arrangement. This dependence increases the risk that the smaller members of SACU will measure the success of the SACU Agreements (1910, 1969 and 2002) in revenue terms rather than in terms of their impact on trade, investment and economic development.

#### **4.3.1.2 Prospects under the new SACU Agreement**

The 2002 Agreement, concluded after eight years of negotiations, sets out a broad framework for enhanced economic integration between member states. McCarthy (2004) emphasises that, in essence, the new agreement depicts SACU as a true international organisation with a legal personality and clear mandates on objectives, institutions, decision-making and financing procedures. A clause in the 2002 Agreement emphasised that any future bilateral trade negotiations would be conducted by SACU en bloc and not by individual SACU member states (this was the case with EU-RSA in 1999). This means that SACU member states have to consider, at least in certain respects, common positions for negotiations (Piazolo, 2002:1210; Southern Africa Customs Union Treaty, 2002; Oyejide, 2004).

The clause was however violated during SADC-SACU negotiation with the European Union for the Economic Partnership Agreement (EPA) in December 2007. South Africa has refused to initial the interim EPA agreement because it includes the agreement in services, which SACU

does not even have an agreement on. South Africa feels cheated SACU partners who have signed the interim EPA (especially on services) but also understand that they had to sign an agreement on trade in goods as the EU has threatened to impose tariffs on their exports that receive favourable preference to the EU market, in particular, the Namibian's and Botswana's beef industry and the Swaziland's sugar industries. (Business Day, 2008:1).

SACU member-states knew that by signing, they are violating the SACU Treaty and this will affect their relation with South Africa. There are threats emanating from South Africa corridors of power aimed at punishing the BLNS countries, but it is unlikely that the political leadership will carry such threat given the importance of the BLNS market for South Africa. In all probabilities, a political solution will be found to a rather economic problem (Business Day, 2008:1).

In addition, the new SACU Agreement provides for the coordination of industrial policy by member states, and also stipulates that all member states have a competition policy. This could have a positive effect on both national and regional industrial development dynamics. The relationship between industrial and competition policy is important with regard to, for example, the promotion of small and medium enterprise (SME) development, and key questions as to the most effective channel of addressing such objectives need to be articulated between these two policy areas.

Other areas open for the developments of common frameworks include competition policy, coordination of customs procedures and trade remedies. However, the 2002 Agreement sets no specific time frame within which to attain its targets (Southern Africa Customs Union Treaty, 2002; McCarthy, 2004).

#### **4.3.1.3 Compensation mechanism in SACU**

According to Viner (1950) and Meade (1955) the adoption of the CET by the members of a customs union provides for compensation for inequality in development and adjustment to the new tariff regime among the member states. Most compensation mechanisms, for example, the Cohesion and Development Fund in the EU, are derived from custom duties imposed on trade with the rest of the world. Poorer member states are allocated funds to fast-track economic and industrial development in the hope that these poorer members will catch up with the developed members in the union. In the EU, Ireland and Spain typify poorer member countries (on entry in 1973 and 1986 respectively) that have benefited from the compensation mechanism of the EU and are, today, on the same level of development as the other wealthier members such as France, Germany and the UK.

The revenue-sharing arrangement derived from custom and excise duties arising from imports from the rest of the world is a longstanding feature of the SACU arrangement. The customs and excise duties are pooled and shared between member states according to their share of intra-SACU trade. In 2007, South Africa contributed 98 per cent of the Common Revenue Pool (CRP), but received far less in receipts. The increase in payment of the SACU transfer has prompted the South African government to call for a review of the formula for the distribution of SACU payments. South Africa argues that the payment to SACU members is unfair and is of the opinion that it should be transformed into a development fund. South Africa will have discretion as regards the usage of this development fund. The discretion on the usage of SACU receipts by BNLS member states will guarantee that the money will be used for economic development through investment in public infrastructure which will, in turn, lower the cost of doing business in the SACU region (Piazolo, 2002; Southern Africa Development Community Report, 2006).

Although the new agreement does provide for democratic decision making in all SACU structures and stipulates the development of common industrial and agricultural policies the approach nevertheless remains fundamentally unchanged. The revenue-sharing formula will ensure that Lesotho, Namibia and Swaziland continue to receive more than one third of their total budget revenue from the pool. This will do little to stimulate economic development and expand the tax base within these countries as they have an assurance of funds from abroad.

Proponents of SACU revenue sharing stresses that the revenue payments are justified because the BLNS are 'forced' to consume South African goods and services as opposed to cheaper alternatives elsewhere. Based on the customs union arrangement of revenue sharing, SACU member countries receive (McCarthy, 1999; 2004). According to McCarthy (2004) the transfer payments are not specifically for dealing with shocks, but they do, however, provide a cushion against revenue losses resulting from the adoption of a CET. SACU analysts have advanced the view that payments are not based on economic performance, but are guaranteed payments by South Africa, thus rendering these payments a form of quasi-fund against revenue shocks.

Despite the clause in SACU agreements indicating that the revenue payable to SACU member states should be used for economic development (in particular industrialisation), records show that member countries use the transfers for current consumption rather than for capital goods such as infrastructure development. However, since the SACU Treaty does permit SACU members to use the payments at their own discretion it is difficult for South Africa to advise BNLS (which are in any case sovereign states) that capital investment is the appropriate way to spend the money unless South Africa succeeds in amending the treaty to grant itself absolute discretion as regards the usage of SACU

receipts by other member states (Southern Africa Customs Union Treaty, 2002).

#### **4.3.1.4 Has SACU benefited its members?**

In terms of the benefits attributable to regional integration in a developing region context, there have definitely been benefits, as well as costs, as a result of SACU membership. For South Africa, SACU has created a captive market of about six million consumers (in BNLS countries) in addition to South Africa's own population of about 48 million. The high GDP per capita in Botswana and Namibia has increased the demand for luxury goods from South Africa. In view of the high imports from South Africa to other BNLS countries, in contrast to the low volume of imports by South Africa, it may be concluded that South Africa has gained an extra market. It is not clear whether South African companies could have produced less in the absence of SACU, but, given its economy, population and the GDP per capita, one may assume that South African companies could have produced sufficient for consumption by its own population and exported the remainder to the rest of the world. There is, however, no denying the fact that the CET among the SACU members does give preference to South African products (in BNLS market) compared with products from the rest of the world (Economic Research Bureau, 2007).

The BNLS countries, maintain the argument that they are a captive market for South African goods through the CET, and that there is an indication of trade diversion favouring South African goods for which the BNLS countries must be compensated. This argument is used in opposition to the review of the revenue-sharing formula, which the BNLS countries view as compensation for the polarisation of industries in the subregion to the benefit of South Africa. Whilst it is undeniable that polarisation and trade diversion does take place under the auspices

of the SACU, it is, nevertheless, difficult to sympathise with the BNLS on their failure to develop their industries and reduce poverty with the aid of the SACU payments.

In their defence, the BNLS argue that, in spite of the provision for infant industry protection inherent in all SACU agreements, it is difficult for them to establish any industry to compete with South African firms that are monopolies and have a first mover advantage in their territories. The imperfect competition within SACU does support, among others, the assumptions of Krugman (1984) and Venables (1990) regarding the imperfect markets inherent in modern customs unions, which has been discussed in Section 2.4.3. In accordance with Viner's (1950) rationale for the creation of a customs union, the BNLS countries would have had a larger market in South Africa, but they have so far failed to penetrate this market due to the lack of diversification<sup>38</sup> in their exports portfolios.

#### **4.3.2 Regional integration experiences in Latin America**

In common with other developing regions, Latin America experimented with regional integration arrangements in the 60s and 70s through the import-substitution strategy. The now defunct Latin America Free Trade Agreement (LAFTA) was the forerunner to more RIAs which were created despite the fact that no tangible economic benefits had been attained. This failure to maximise benefits in regional economic integration arrangements in Latin America may be attributed to the models of import-substitution which were adopted, as these models were biased towards supporting import competing industries. LAFTA included the ten independent countries of South America as well as

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<sup>38</sup> The BNLS countries produce mainly primary goods, but South Africa also produces these primary goods in abundance. The production structures of SACU members do not complement each other, making it difficult for South Africa to import from BNLS countries and for BNLS countries to import from each other.

Mexico, while the Central America Common Market (CACM) comprised the five countries of the Central American peninsula.

In the case of LAFTA, the negotiating mechanism was more cautious and gradual. The large and medium-sized members had built up national industries on the basis of protectionist criteria which were still widely adhered to. The industrial structures of the major countries overlapped to a marked degree, and the limited size of national markets reduced the scope for specialisation and economies of scale. The limitations thus imposed by domestic market-oriented development were highlighted in a number of studies produced at the time by the Economic Commission for Latin America (ECLAC) — a leading advocate of the integration process at the time. The protected development strategy based on import-substitution industrialisation began to lose credibility in the 1970s.

On the one hand, a number of large and medium-sized countries in South America experienced periods of rampant inflation. Subsequently, there was a large inflow of 'petrodollars'<sup>39</sup> from the strengthened world petroleum cartel, and these were offered by private commercial banks at negative real interest rates. This stage coincided with a period of stagflation in the US and other major developed countries. This, in turn, produced a type of subsidy for countries in receipt of credits.

These cheap and abundant Petrodollars flows to Latin America appreciated exchange rates, opening the way for trade liberalisation

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<sup>39</sup> Petrodollars are the receipts from oil purchases, which are quoted in US dollars. The owners of the Petrodollars are the oil-producing countries, the majority of which are Arab countries which have benefited from the increase in the oil price since the 70s. Most of the Petrodollars were deposited in Western Banks and used as loan funds to the developing regions.



that began to weaken the uncompetitive Latin-American industries (World Bank, 2000). The experience of Latin America provides a lesson to the Southern Africa region that an import-substitution strategy, even as regional policy is not sustainable and is a drain on resources that could have been used for other areas of economic development.

#### **4.3.2.1 Regional integration in the Southern Common Market (MERCUSOR)**

Although there are various RIAs in Latin America, this section will focus on the integration of the Southern Common Market (MERCUSOR), which is a customs union in South America. It undoubtedly represents the most ambitious attempt at regional integration in Latin America because it involves the two large economies of Brazil and Argentina, together with Paraguay, Uruguay and Venezuela (which joined in 2007). According to Klonksy (2007) MERCUSOR has a combined GDP of US\$ 2, 9 trillion and a population of more than 260 million people (World Bank, 2005a). Argentina and Brazil accounts for 90% of intra-MERCUSOR commercial exchange whilst intra-regional trade for all five member amounts to 25 per cent of total trade. The first positive impact of MERCUSOR has been the growth in intra-regional trade from US \$10 billion in 1994 to more than US \$20 billion in 2000. The success of MERCUSOR in comparison with other RIAs in Latin America depends political stability and the fact that the customs union has two strong emerging market economies in Brazil and Argentina hence it has attracted other South American countries such as Bolivia, Chile, Peru, Ecuador, and Columbia, all of whom have joined as associate members (Frankel *et al*, 1995; World Bank 2005a).

The limitations regarding the benefits of MERCUSOR membership may be attributed to the construction of the CET, which does not cover all areas of trade. If a CET has a narrow coverage, most trade tends to fall

outside customs union and this encourages members to maintain tariffs with each other (Mistry, 1996: 17; Coleman & Underhill, 1998; World Bank, 2005a). The potential benefits will be realised once all the members have agreed to complete regional trade liberalisation which will lead to the inclusion of all trade under MERCUSOR.

#### **4.3.3. Regional integration experiences in East Asia**

According to Mistry (1996:19), the ten-member<sup>40</sup> South East Asian Nation (ASEAN) represents the third major region of the world economy after the EU and NAFTA. Since its inception in 1967 ASEAN has made progress in terms of intra-regional trade (which comprises approximately 55% its total global trade) and the creation of joint policies in investment. The achievements of ASEAN economic integration happened despite the absence of a formal regional institutional integration framework<sup>41</sup> in its earlier years (World Bank, 1994; ASEAN, 2002; Ariff, 2006).

In fact, although the aims of ASEAN were originally intended to focus on economic, social and cultural development, the association played a significant role in fulfilling the political needs of South-East Asian nations at the time. These political accomplishments included normalising relations between Malaysia and Indonesia, and forging an alliance among the non-communist members of the region. Although integration in both Europe and East Asia was originally for political reasons, thereafter the driving force behind integration differed in both cases. In Europe, the instigators were governments and regional

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<sup>40</sup> ASEAN comprises of Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam.

<sup>41</sup>.In 1967 ASEAN was a cooperative agreement of limited scope. The ASEAN Free Trade Area was adopted in 2004.

institutions (both political and economic); while in East Asia it was corporations and markets (Dick, 2002; Asian Development Bank, 2004). ASEAN integration is more of a cooperation agreement, but the general commitment to the ASEAN Free Trade Area (AFTA) by the ASEAN governments will indeed deepen economic integration. East Asia has recorded tremendous growth in recent years (1986-2005), outpacing both North America and the EU. The Asia Financial Crisis of 1997 brought ASEAN members together in the belief that such cooperation would help the region avert such catastrophes in the future (Siggel, 2005: 191), hence the institutionalising of ASEAN through linear integration processes in 2004 when AFTA came into force.

#### **4.3.3.1 The costs and benefits of ASEAN economic integration**

According to Dick (2002) the East Asian integration model, in contrast with other developing region integration models, better fits the market-driven integration process scheme. The market and corporations-driven process in East Asia has been encouraged by the development of both regional and global cross-border production networks. Intra-industry trade in parts and components and foreign direct investment conducted by corporations and encouraged by significant liberalisation have been and continue to be the key driving forces of the established production-sharing scheme. The adoption of the ASEAN Free Trade Agreement (AFTA), formed in 2004, has not led to any significant increases in intra-ASEAN trade,<sup>42</sup> but this is not because of the minimal use of the preferential tariffs. The main reason for the latter may well be the small preferential margins, now that the most favoured nation tariffs in ASEAN countries are relatively low. Another explanation could be the stringent customs procedures that many small and medium enterprises find too cumbersome. However all these arguments serve only to explain why traders might not want to use the common effective

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<sup>42</sup> Intra-ASEAN trade is at 55 per cent of total trade, at the same level as before the formation of ASEAN FTA.

preferential tariffs facility, but not why intra-ASEAN trade still accounts for a small proportion only of the total trade of ASEAN.

The other reason for low intra-regional trade is that ASEAN economies compete with, rather than complement, one another, as all of them compete in the area of high-value-added manufacturing such as electronics and automobiles. Ariff (2006) maintains that the aim of AFTA was not to create an internal market, but too make ASEAN products internationally competitive so that ASEAN exports to the rest of the world would grow. According to the Asian Development Bank (2004) it is not really significant whether exports go to a partner country or to a non-partner destination.

AFTA seems to have led to considerable rationalisation of the production activities of multinationals for supplying the global market rather than the region. In other words, intra-regional trade is not a good measure of the success of regional integration efforts in ASEAN. Integration in ASEAN is better measured in terms of attraction of FDI, political and economic stability, and the diversification of production structures from the production of primary goods to high-value manufactured goods.

#### **4.3.3.2 What does the future hold for ASEAN?**

The rise of China has altered the East Asian equation in a variety of ways. It was without a doubt the Chinese factor that expedited the ASEAN integration process in the mid 90s. The diversion of foreign direct investment from ASEAN to China and the loss of ASEAN's export market share to China have forced ASEAN to quicken the pace of AFTA so as to create a single ASEAN market large enough to constitute an attractive destination for foreign direct investment. An

integrated ASEAN market was seen as a counterweight to China's huge market, notwithstanding the fact that China is more than twice the size of ASEAN in terms of population<sup>43</sup> and GDP (World Bank, 1994; Asian Development Bank, 2004).

China's north-east and south-east linkages have grown enormously in recent years. Japanese and Korean investments in China have increased significantly, and this has led to a strengthening of China's trade links with Japan and Korea. ASEAN investments in China have also increased sharply, while China has emerged as a major trading partner for ASEAN. The composition of ASEAN–China trade has changed dramatically with intra-industry trade in capital goods accounting for a growing share of the total, which was previously dominated by primary products.

While tariffs have been significantly reduced, there are still non-tariff barriers in certain East Asian countries that could seriously inhibit trade flows. There is also considerable need for further reforms that could improve the commercial environment for both foreign and domestic enterprises.

These reforms include more effective research and development (R&D), better physical infrastructure, legal reform, improved education, and administrative reform. Furthermore, the participation of East Asian countries in production networks is growing not only on a regional basis but also on a global basis (Asian Development Bank, 2004; Ariff, 2006).

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<sup>43</sup> The population of China is estimated at 1.3 billion whilst its GDP is US \$3.2 trillion at current prices.

#### 4.4 Regional integration processes in Africa

At a continental level, the broad objective of the African Union (AU)<sup>44</sup> is, as stipulated in the Abuja Treaty of 1991, to establish an African Economic Community (AEC) by means of a gradual process comprising six stages over 34 years. In pursuance of the objectives of the Abuja Treaty (1991) towards the common goal of establishing the AEC, the AU is also currently engaged in a process of rationalisation of the 30 RECs. In this regard, the AU Assembly adopted a moratorium<sup>45</sup> on the recognition of RECs that will graduate into the AEC. The AU has been selected at the highest political level as the framework which will link Africa before integration to the rest of the world (Njinkeu & Gitonga, 2005; Africa Integration Review, 2007).

There are approximately 30 regional economic communities (RECs) on the African continent, with each country belonging, on average, to three such regional economic communities. In many cases, countries belong to integration schemes with inconsistent liberalisation schedules (McCarthy, 1999). Despite efforts by African countries to reduce tariffs through regional and multilateral initiatives, Africa's share of world trade has fallen from 6 per cent in 1990 to 2 per cent in 2002. African countries also scarcely trade with themselves; five percent compared to 46 per cent in NAFTA, 55 per cent in East Asia and 62 per cent in the EU. This low intra-regional trade may be attributed to technical barriers as well as to the lack of infrastructure; in particular, road and rail infrastructure which would lower transaction costs between member countries. In contrast to other regions, Africa's RECs display high transport costs between member states. For example, transport costs in

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<sup>44</sup> The Constitutive Act establishing the African Union came into force on 26 May 2001.

<sup>45</sup> The Moratorium was adopted at the AU Summit held in Banjul, Gambia in 2005.

Southern Africa are on average 73 per cent higher than in the US or Europe (Economic Commission for Africa, 2005; World Bank, 2007; African Development Bank, 2007).

Regional economic integration in Africa is pursued as a result of the small markets of the member states and the impact it might have on economic development, which would result in an improvement in the welfare of the African people. African countries are not able to confront the forces of globalisation alone, hence the necessity to integrate the economies of the African regions so that these regions may benefit as a result of the increased market that will lead to scale production. According to Viner (1950) and Lipsey (1957), competition from abroad should stimulate innovation among import-competing industries, and this would lead to increased production efficiency. Enterprises in Africa face supply-side constraints such as transport costs and technology and these affect their ability to respond quickly to increased competition from abroad. The resultant loss in market share often leads to the closure of firms in the affected industries.

Despite the stringent RoO that are in place to reduce the influx of cheap foreign imports in the region. Oyejide (2004) points out that some external actors build final assembly plants in SADC countries in order to circumvent this control mechanism. These final products are then exported to the markets of EU and US as if they originate from SADC. This practice has eroded the market share for import-competing industries in African countries and has had negative implications for intra-African trade.

The discussion on RECs in Africa will be presented in terms of four geographical areas, namely Eastern and Southern Africa, Central Africa, West Africa and North Africa. Furthermore, the discussion will focus on the structures of RECs as well as the evaluation of the

economic effects of regional integration on member countries. The effects of regional integration and economic development in Southern Africa will be discussed in detail in Chapter 5.

#### **4.4.1 Eastern and Southern Africa regions**

As Chipeta (2006) and the Economic Commission for Africa (2005:155) point out, regional economic integration in Eastern and Southern Africa (ESA) has been actively pursued with the twin objectives of fostering economic and political development, and arresting the further marginalisation of the region and its communities. These communities are, in the main, poor, underdeveloped and vulnerable to the harsh realities of globalisation. Deeper regional integration is of the utmost importance if Eastern and Southern Africa are to achieve meaningful industrialisation, develop higher levels of intra-regional trade and investment flows, reduce poverty and participate effectively in the evolving global economic linkages.

A further examination of the various regional structures and agreements in Eastern and Southern Africa highlights the potential problems of overlapping membership, particularly among those members with commitments to forming a customs union and those who are negotiating economic partnership agreements (EPAs) with the EU. The problems of road/rail/port infrastructure inhibit the potential of the countries in the subregion to trade efficiently. Even in cases where the tariff barriers have been reduced significantly amongst member states, non-tariff barriers of all sorts continue to constitute an obstacle to trade.

As pointed by McCarthy (1999), the problem also exists that countries of the subregion compete in the production of similar goods, namely, primary commodities. Without the diversification of production structures intra-regional trade will remain low even when the tariff and



non-tariff barriers are absent. The polarisation effects are fairly high when South Africa is included in the equation. South Africa's larger population, its wealth, high GDP per capita and industrialisation mean that industries seeking expansion in the region tend to move south, taking advantage of the larger population and high levels of economic development in order to attain the maximum profit.

In Eastern and Southern Africa there are the following four main regional economic communities (RECs) which are all aiming for deeper integration, namely:

- Common Market for Eastern and Southern Africa (COMESA)
- East Africa Community (EAC)
- Southern African Development Community (SADC)
- Southern African Customs Union (SACU)

According to SADC Today (2006:3) the Africa Union<sup>46</sup> recognises only the EAC, COMESA and SADC in Eastern and Southern Africa as the means for the projected African Economic Community (AEC). The failure to recognise SACU is a point of concern as SACU is the most successful customs union in Africa and is recognised by the WTO. This may be largely attributed to South Africa and other SACU members which have failed to defend the success of SACU and press for its inclusion as a building block in the AEC. Furthermore, SACU has

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<sup>46</sup> During the African Union Summit held in Banjul, Gambia (2006) the moratorium was passed according to which only eight RECs in Africa are recognised as the building blocks towards the establishment of the African Economic Community in 2028. Of these eight, only SADC, COMESA and East African Community (EAC) have been identified in the Eastern and Southern Africa regions.

successfully concluded agreements with, among others, the US, the EU and China.

#### **4.4.1.1 Overlapping membership in the Eastern and Southern regions**

While the existence of numerous agreements within the region does not in itself constitute a problem, it does mitigate the benefits to be obtained from integration. According to the African Economic Commission (2005) and ADB (2007) overlapping membership between the groupings has the potential to cause conflict and certainly imposes greater transaction costs on the business communities and governments. As these regional groupings move toward deeper trade and economic integration, these problems become more severe. The move toward free trade areas (FTAs) within the above groupings has so far been technically possible, but the next stage of establishing a customs union (CU), to which all RECs aspire, is not. Within an FTA, each country has autonomous control of their external trade agreements, but the countries may not grant a greater degree of preferential treatment to any third party than they grant to the current members of the FTA. Within a customs union, however, this autonomy is lost and each member of the CU must adopt the CET of the group and apply this rate to all third parties. It is not realistic for one country to apply two different external tariffs (Krueger, 1997). In Eastern and Southern Africa, the EAC and SACU are already customs unions, whilst COMESA and SADC are planning to launch customs unions in 2008 and 2010 respectively.

Multiple memberships of overlapping customs unions with different trade regimes are geographically, economically and politically unsustainable (Vickers, 2006). According to GATT Chapter XXIV (1993) it is not possible for any member state to belong to more than one customs union regime, unless each of these regimes adopts identical trade regulations and the same CET. It is technically unrealistic to

belong to two different customs unions. This development in Southern Africa mirrors that of all sub-Saharan African (SSA) regions and is a major obstacle to the development plans of the regional economic communities in SSA (Mistry, 1996; Siggel, 2005; Berteslmann & Draper, 2006).

According to Africa Today (2006) and Pearson (2004; 2006) EPA negotiations with the EU add another layer to these overlapping intra-regional processes, since the new partnership agreements and related tariff reductions are to be negotiated and implemented by the African, Caribbean and Pacific countries subregions (which include among others the Southern African countries) and not individual states. Hence, countries in the region have chosen the configuration in which they wish to participate – either Eastern and Southern Africa<sup>47</sup> (ESA) or SADC-minus which comprises five SACU members plus Angola, Mozambique and Tanzania.

The EPA negotiation has sown confusion in Southern Africa since it has divided countries into groups that are not compatible with the traditional RECs in Eastern and Southern Africa. Since many of the EU developmental grants will be linked to the outcome of the EPA negotiation (expected in December, 2007), Southern and Eastern African countries have taken the decision to convert their regional communities into customs unions, irrespective of whether the conditions are ripe for such a development, but this is a requirement for EPAs. If the ESA and SADC-minus group present different tariff preference to the EU, this will have the potential to frustrate efforts by both SADC and

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<sup>47</sup> The ESA configuration consists of Burundi, Comoros, Djibouti, Eritrea, Ethiopia, Kenya, Madagascar, Malawi, Mauritius, Rwanda, Seychelles, Sudan, Uganda, Zambia and Zimbabwe. At the end of 2005 the Democratic Republic of Congo (DRC) decided to suspend its membership in the ESA EPA configuration and change to the Central African group.

COMESA to graduate into customs unions within their traditional configurations.

#### **4.4.1.2 The rationalisation of RECs in Eastern and Southern Africa**

The programme of rationalisation of RECs is informed by the AU Gambia Declaration, which seeks to speed up the integration process at eight RECs identified as the building blocks of the African Economic Community. The rationalisation process in Eastern and Southern Africa (ESA) is beset with complexities. Most countries are still in the process of implementing the trade liberalisation programme of COMESA with the progressive adoption of the four-band common external tariff of 0 per cent for capital good, 5 per cent for intermediate goods, 15 per cent for primary goods, and 30 per cent for agricultural goods respectively. Certain countries (Kenya, Madagascar, Malawi, Mauritius, Zambia and Zimbabwe) had implemented the intra-COMESA FTA decision by 2000, whilst the following countries had managed to achieve the low simple average tariff rate within the COMESA CET range: Madagascar (5.7%), Malawi (13.4%), Rwanda (9.9%), Uganda (9.0%), and Zambia (14.0%). Several other countries in this group have average tariffs of below 20 per cent, although their maximum rates were much higher than that specified by COMESA's CET, i.e. Ethiopia (18.8%), Kenya (17.1%), Mauritius (19.0%), and Zimbabwe (18.3%).

Within the Eastern and Southern Africa EPA subregion, a limited number of countries only have simple average tariff rates in excess of 20 per cent and these include Djibouti (30.8%) and Seychelles (28.3%). In the SADC EPA subregion most of the member countries are also SACU members. In 2002 the simple average tariff rates of countries such as Botswana, Lesotho, Mozambique, Namibia, and Swaziland were uniformly 11.4 per cent which was within the range of 0–60 per cent established by SACU's CET. In the case of Tanzania, the simple

average tariff rate in 2000 was 16.3 per cent with a maximum rate of 25 per cent (Oyejide *et al*, 1999).

Rationalisation will necessitate a review of the tariff lines to ensure a rapid convergence to a uniform level. A variable geometry appears to be the suitable option for this convergence programme. A variable geometry is a term used to describe the method of differentiated integration which acknowledges that there are irreconcilable differences within the integration structure and therefore allows member states to join when they are ready for the process.

The case of the East Africa Community (EAC) is more problematic, however, as four of its members (Burundi, Kenya, Uganda and Rwanda) are in COMESA while Tanzania is in SADC. Unless there is harmonisation of external tariffs between COMESA, EAC and SADC, the project of deepening EAC integration is bound to fail (Oyejide *et al*, 1999).

#### **4.4.2 Regional economic integration in West Africa**

The Economic Community of West African States (ECOWAS) has been designated as the building block for the AEC for West Africa. The following countries are members of ECOWAS: Benin, Burkina Faso, Cape Verde, Côte d'Ivoire, Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Niger, Nigeria, Senegal, Sierra Leone, and Togo. With the exception of Guinea all French-speaking members of ECOWAS (namely Benin, Burkina Faso, Cote d'Ivoire, Mali, Niger, Senegal, and Togo), together with Guinea Bissau, have formed a customs union and a monetary zone through the West African Economic and Monetary Union (WAEMU). This move led to further reform as a result of the involvement of the regional central bank, namely, the BCEAO (Economic Commission of Africa, 2005).

WAEMU has generally been perceived to have been successful (Economic Commission for Africa, 2005). There has been a significant increase in the development of convergence criteria with harmonisation in such areas as public finances, public sector reform, budgetary and accounting classifications of local governments. The most significant progress has been in the harmonisation of indirect taxes, namely, value-added tax (VAT) and excise tax. Since November 1997, the Union has implemented the harmonisation of the West African accounting system (SYSCOA). The West African Development Bank (BOAD) is the financial arm of WAEMU. It concentrates on such activities as investment projects and integration-promoting infrastructure.

There has been significant progress with respect to the free movement of people and the implementation of a CET for trade. A common commercial policy has harmonised national efforts within such frameworks as the World Customs Organisation (WCO), the WTO, bilateral arrangements such as within AGOA and with the EU. A compensation mechanism has been introduced to compensate for revenue loss resulting from harmonisation. At the sectoral level the Commission has commissioned regional programmes in the areas of energy, agriculture, environment and infrastructure (Economic Commission for Africa, 2005). Despite the progress made in deepening regional integration in West Africa economic development and poverty remains a problem. This could be attributed to the absence of a trickle-down effect of the economic benefits to touch the lives of the ordinary citizens.

#### **4.4.3 Regional economic integration in Central Africa**

The Economic Community of Central African States (ECCAS) is the recognised regional bloc for Central Africa. ECCAS comprises Angola,

Burundi, Cameroon, Central African Republic, Chad, Congo Democratic Republic, Congo Republic, Equatorial Guinea, Gabon, Rwanda, and Sao Tomé and Príncipe. There is also a variable geometry approach within the ECCAS region with six members having belonged to a customs union and monetary zone, the Economic and Monetary Community of Central Africa (CEMAC) since 1994. These members of CEMAC are Cameroon, Central African Republic, Congo Republic, Gabon, Equatorial Guinea, and Chad.

CEMAC also shares several economic institutional cooperation arrangements with other French speaking West African countries on such policies as exchange rates, insurance, business law and intellectual property rights. In the Central African region intra-regional trade is insignificant at less than 10 per cent of total trade.

Trading between members follows a hub-and-spoke pattern – a situation where smaller and poorer members of the regions rely on regional trade from wealthier and larger members who trade primarily with non-members (Economic Commission of Africa, 2005, Shams, 2005). There is a lack of complementarities in the exportable as member countries produce the same products, namely, petroleum, minerals and agricultural products, for export outside the region.

#### **4.4.4 Regional Economic Integration in North Africa**

According to the Africa Economic Commission (2005) and Bensouiah (2002) the Arab Maghreb Union (UMA), comprising Algeria, Libya, Morocco, Mauritania, and Tunisia, is the building block for North Africa. A particular feature of the AMU is that Arab countries outside Africa may apply for membership.

This region is not negotiating Economic Partnership Agreements (EPA) although separate agreements do already link certain of the countries to the European Union. The union exists more as an Arab solidarity forum than a regional economic integration arrangement and has closer links with the Middle East than with sub-Saharan Africa (Siggel, 2006).

The economies of the Maghreb countries are sustained by large contributions from customs duties imposed on foreign trade, and any reduction in these tariffs would decrease the revenues available to their governments. In Tunisia, for example, customs tariffs account for 22 percent of government revenues, while imports from European countries represent 71.5 percent of the total imports.

A reduction in tariffs by adopting a lower CET than the prevailing one would result in significant reduction in the revenue from custom duties. A reduction in the value of customs duties would lead to a decrease in the level of public expenditure. Unless fiscal reform, such as a broadening of the tax base (to reduce the dependency on tariffs as a source of revenue), is introduced, countries will continue to maintain their external tariffs and this will slow down the process of regional economic integration in Maghreb (Bensouiah, 2002).

#### **4.5 The economic and developmental effects of African economic communities**

Africa's record in regional integration since independence has been disappointing. To date African countries have formed over 200 regional cooperation organisations. Most of these have concentrated on economic integration, but not one has been able to achieve the goal of genuine regional economic integration. The most common problem that led to the failure of African economic integration arrangements during



the period 1960-1994 may be attributed to the application of an import-substitution strategy and protectionism of most regional groupings during the first and second waves<sup>48</sup> of regionalism. Shallow integration, based on import-substitution and physical integration, has failed in Africa. Hardly any of the African trade blocs have been successful in terms of economic development, industrialisation, growth of intra-regional trade and the reduction of poverty (McCarthy, 1994).

Therefore, it seems justifiable to conclude that the signing of treaties and the establishment of regional institutions have not resulted in economic integration in Africa (Mistry, 1996:561). The successes of African regional schemes have proved to be limited when measured in terms of traditional gains from regional economic integration terms. It is only the arrangements in Francophone West Africa (in particular WAEMU) and in Southern Africa, for example SACU, that have had limited success in terms of a customs union, while attempts at deeper economic integration in the rest of the Africa have not produced any appreciable benefits (Mistry, 1996:556).

The bureaucracies managing the regional organisations have been weak, and none of the regional communities has been able to boast of a bureaucratic institution similar to that of the EU. The presence of well-functioning bureaucracies at regional level would have either promoted the regional interest or overseen that regional commitments were transformed into effective national policies, as has been the case with the European Commission. Even the newly created regional economic communities, such as SADC, have, in their design structures, granted

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<sup>48</sup> Regional economic integration has gone through three phases (waves), the 1960s and 1970s (first wave), the late 1980s and early 1990s (second wave) during which the RECs were created for regional self-sufficiency based on the import-substitution paradigm, and the current period that is based on an export oriented strategy.

as little power as possible to the supranational level (Mistry, 1996:557; Chipeta, 2006; Economic Research Bureau, 2007).

#### **4.5.1 Unwillingness to cede sovereignty**

The unwillingness on the part of African governments to cede at least some degree of sovereignty in matters of common regional interest in order to achieve long-term regional economic goals has contributed to the failure of African integration arrangements. The lack of monitoring and enforcement mechanisms to ensure adherence to agreed timetables led to African governments' failure to translate their commitments in regional treaties into substantive changes in national policies, legislation, rules and regulations. There was also no follow through in translating regional commitments into national actions.

The bureaucracies established to manage the African economic communities suffer from indecision and a shortage of skills and funding to enforce the regional agenda. Many countries that are members of RECs face a difficult trade-off between public revenue losses from trade liberalisation and the benefits arising from trade integration which will be only realised in the long term, thus making it difficult for political office bearers to influence their constituencies into buying into the regional integration agenda. This tends to produce delays in the ratification of trade protocols and postpones the implementation of these policies (Economic Research Bureau, 2007).

#### **4.5.2 Low volumes in intra-regional trade**

Despite enthusiasm about the formal adoption of regional trade arrangements in Africa intra- and inter-regional trade continue to lag behind other RIAs in both developing and developed regions. On average intra-regional trade in the African RIAs is less than 20 per cent

of its total global trade (Rodrik, 1998; Longo & Serkkat, 2004). Trade is also constrained by a lack of diversification, which is due to the high concentration on similar primary commodities and a lack of value-adding, as well as the marked exclusion of the informal sector trade.

Furthermore, RIAs tend not to honour their own commitments, pay insufficient attention to distributional consequences, and are characterised by inadequate funding of regional projects and initiatives. The poor trade and development performances of African countries suggest that the overall approach to regional integration needs significant revision in order for it to provide a framework for accelerating trade and promoting development in the 21st century (Foroutan & Prichett, 1993, Mistry, 1996; Longo & Serkkat, 2004). Small and remote economies are inherently uncompetitive primarily because of the misfortune of diseconomies of small scale and high transaction costs. These countries cannot generate adequate quantities of competitive exports of an acceptable quality, and are not able to attract significant amounts of foreign investment. They could strive to overcome the constraints of small internal markets by specialising and trading internationally, however, exporting at world prices would be either impossible or would generate factor incomes not sufficiently high enough to address the chronic poverty in their countries (Winter & Martins, 2004; Wilson *et al*, 2004).

Even if tariffs were to be reduced to zero, technical or non-tariff barriers (NTB) would remain an obstacle to free trade. African countries have all manner of requirements, such as quality standards, health standards and others, that prevent the free flow of goods across borders. The removal of NTB constitutes another domain which African regional integration should prioritise. For example, the harmonisation of product standards, certification and accreditation systems, transport links and

customs harmonisation could prevent the border delays that are encountered when each individual country has its own requirements (UNCTAD, 2007).

Freedom of transit is the cornerstone of African regional integration schemes and this encompasses provisions for transportation, border crossing, the harmonisation of relevant national regulations and the development of coherent infrastructure networks for road, rail and inland waterway transport. For example, the ECOWAS Treaty mandates that each member state provide for full and unrestricted freedom of transit through its territory for goods proceeding to or from a third country indirectly through that territory or to or from other member states. If this mandate were enforced, transit would not be subject to any discrimination, quantitative restrictions, duties or other charges for member states (Mistry, 1996; Oyejide, 2004; Shams, 2005).

#### **4.5.3 The challenges of financing infrastructure development in Africa**

African countries suffer from an infrastructure backlog, some of which dates from the period of independence. The lack of road, rail and port networks within member countries and across the sub-Saharan region constitutes an impediment to trade. The state of neglect of these transport networks is such that it will take billions of American dollars to improve the situation and many African countries do not have financial capability to fund infrastructure development. The backlog of infrastructure development is such that no single country could address the problem individually and, since the benefit of infrastructure renewal would accrue to the whole region, it is imperative that regional funding be used for infrastructure projects. A lack of resources on the part of member countries would hamper any potential funding for bigger projects. The use of development financial institutions such as the

World Bank, the African Development Bank, the Development Bank of Southern Africa and the Industrial Development Corporation as funding vehicles for infrastructure development would alleviate the burden on member countries. It is essential that African countries establish development funds that will be used for regional development projects. Each member country will have to contribute a portion of its GDP to the envisaged fund.

The use of pension funds to develop infrastructure within each member state could also help address the problem of lack of funding inherent in many African countries (Limao & Venables, 2001; Africa Economic Commission, 2005). However, one is forced to acknowledge that, with the exception of South Africa, none of the sub-Saharan African countries have accumulated pension funds of sufficient magnitude to fund the infrastructure backlog. South Africa would also not be prepared to use its own pension fund to prop up regional projects as this would not be politically or economically sustainable. This dilemma is further compounded by the perception in the Southern Africa region (and to an extent the whole of the continent) that South Africa is playing a big brother role similar to that of the US and, even when South Africa's intentions are good, the prospect of using South Africa's pension fund for regional/continental projects might be rejected on the basis of such a perception.

#### **4.5.3.1 Case study IV: The Pan-African Infrastructure Development Fund**

The case study reflects the successful mobilisation of African pension funds for infrastructure development on the continent. The most important development regarding the mobilisation of pension funds for infrastructure came from the commitment by the NEPAD Heads of State

and Government Implementation Committee (HSGIC)<sup>49</sup> who recommended the investment of African Pension Funds in selected high priority infrastructure projects. The Pan-African Infrastructure Development Fund is aimed at creating a platform for basic infrastructure for accelerating growth for sustainable development in Africa. The Fund will focus on infrastructure sectors: transportation (roads, rail, ports, and airports), telecoms, water and energy projects in gas and electricity (Africa Integration Review, 2007; Economic Commission for Africa, 2007).

As a result of the NEPAD Heads of State and Government Implementation Committee (HSGIC) resolution, the Pan-African Infrastructure Development Fund (PAIDF) was launched at the ongoing 9th African Union Summit in Accra, Ghana in 2006, with an initial seed capital of US\$ 625 million raised from eight investors within the continent. The initial investors included Ghana's Social Security and National Insurance Trust (SSNIT), South Africa's Public Investment Corporation (representing South African Pension Fund), the African Development Bank (AfDB), the Development Bank of South Africa and the Barclays Bank/ABSA Group. The rest were Metropolitan, Old Mutual Group and Standard Bank Group all from the southern part of Africa. To date, it has raised US \$1.2 billion to serve as a financing platform for infrastructure development on the continent. The fund is based in South Africa (Africa Integration Review, 2007).

According to the African Development Bank (2007), there are already 18 projects in the pipeline vying for funding from the PAIDF. The stringent investment procedures by the fund are that not more than 25 per cent would be invested in a particular region, not more than 20 per

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<sup>49</sup> NEPAD Heads of State and Government Implementation Committee comprises of the presidents of Algeria, Ethiopia, Nigeria, Senegal and South Africa.

cent would be invested in a particular country and not more than 30 per cent in a particular sector. The identified 18 projects would require 4.2 billion US dollars but the PAIDF currently has 1.2 billion US dollars, which is intended for the most viable projects. This clearly illustrates that with commitment, African countries can mobilise resources to solve the problem of under-development. Although the funds raised are not nearly enough to solve the state of infrastructure decay, it does serve as a positive signal to foreign investors that the Africans themselves are committed to addressing the infrastructure backlog.

#### **4.6 Lessons for the developing regions from the EU integration process**

The EU is a fully functioning economic union to which many developing RIAs aspire at some point in the future. The records of the various early regional arrangements in the developing world (and Africa in particular) have, in general, not been encouraging. In part this is due to what Mistry (1996) and Schiff and Winters (2003) term a 'fallacy of transposition', which refers to coping the EU integration scheme without having similar economic structures. Governments of developing countries have misinterpreted the European process as a case of limited cooperation without surrendering national sovereignty, and have tried to emulate this in their own countries. However, many pre-existing conditions, which were conducive to integration in Europe, have been overlooked, for example a high level of intra-regional trade before integration, similarities in income and industrialisation levels allowing for intra-industry specialisation, corresponding interests in foreign affairs, and a willingness and capability to provide compensation payments to replace revenues forfeited as a result of the liberalisation of tariff and non-tariff barriers (Oyejide *et al*, 1999; Longo & Serkkat, 2004).

The developing regions failed to acknowledge that the EU had already undergone economic development and industrialisation before the deepening of integration between member countries and, in its current phase, European integration seeks to attain a higher and more consistent economic growth. Developing countries, on the other hand, still need to pursue economic development with vigour. This need is illustrated by the infrastructure backlog and massive poverty in the developing regions, which, if not addressed, will mean that economic integration, will remain elusive. Despite problems with previous attempts at integration, a renewed interest in regional integration schemes was observed in the 1990s which saw a shift from import-substitution strategies to outward-oriented industrial development strategies. Despite the fact that the state still occupies the centre position in regional economic integration there has been an acknowledgement that the private sector has to be involved in regional integration as the state is not able to produce efficiently for both the domestic and foreign markets.

The success of EU integration rests on the undertaking by the European leaders that they all genuinely need to integrate their economies, hence their acceptance that they would have to cede some degree of sovereignty to the supranational body. For example, all the members of the Euro zone have accepted that they have to transfer macroeconomic policymaking to the EU Central Bank and abide by the Convergence Criteria. This also holds true for other EU institutions, such as the Parliament, the Commission, and the Court of Justice, in which member states are represented by their top personnel. The EU is a well-functioning region with an efficient bureaucracy that deals with the day-to-day management of the institution.

With regard to governance, most African countries face unstable political environments as well as regional tensions and instability. The



effective implementation of regional cooperation frameworks will only take root in healthy, democratic environments in which economic management are both transparent and accountable (Fabricus, 2006). Leaders with vision and the will to implement change are essential to build this kind of political security. Apart from political and economic prerequisites, the availability of indigenous institutional capacity is also vital. A strong institutional setup at regional and national level is fundamental, and links between national and regional institutions (the interface level) are required to integrate regional agreements into national policy.

In conclusion two lessons may be drawn. Firstly, there can be no effective regional economic integration without national integration and participation. The European experience has shown that national-level arrangements, such as inter-ministerial coordination committees or consultation mechanisms with chambers of commerce, trade unions and pressure groups, are essential for effective participation in regional initiatives.

Efforts at the regional level will be sustained only if African countries first put their own domestic houses in order. Secondly, there are no simple recipes or models. Success or failure hinges on the specific context and environment, in which the cooperation is to operate, and care must be taken not to transplant or copy models from different contexts and circumstances. These models must be adapted to local needs and realities. Some of the approaches and mechanisms from Europe that may be useful in Africa are the principle of subsidiarity, targeted policies to reduce welfare disparities between regions, and the gradual implementation of RIAs at different rates, in other words, variable geometry.

#### **4.7 What may be done to advance regional integration in Africa: The way forward?**

Despite all the efforts to consolidate regional integration in Africa, economic development has remained elusive and the continent's percentage share of global trade continues to decline. Furthermore, Africa has not caught up with other developed regions in terms of welfare improvements exemplified by low GDP per capita and worsening in terms of trade. In order to arrest this decline, African countries have to find a way of confronting the challenges that constrain regional economic integration. The following suggestions are proposed as a way forward for Africa to end its decline and accelerate that development that is inherent in regional economic integration:

##### **4.7.1 African countries should honour regional commitments**

African governments will not be taken seriously by the private sector (domestic and foreign) if they continue with the proliferation of RIAs that are largely under-funded, given conflicting mandates or have no concrete actions on the ground. The rationalisation process needs to be concluded urgently.

As discussed Section 4.4.1.2, it is not possible to generalise. In some cases, for example, in Central and West Africa, a variable geometry approach could work, whilst in a second category (e.g. COMESA and SADC) each of the schemes has accumulated experience that should be factored into the consolidation. Where there is an inconsistency (e.g. membership of two customs unions) political decisions based on the potential economic benefits that could accrue will have to be made with respect to which regional economic community is preferred (Mistry, 1996; Siggel, 2005).

#### **4.7.2 Regional policies must be infused into the national agendas**

According to Coe and Hoffmaister (1998) there is a need for liberalisation on the African continent with the focus on intra-regional, and then inter-regional trade liberalisation towards the formation of the African Economic Community. A transparent, predictable and rule-based global trade and economic system will foster growth and development in Africa, hence the need for active engagement in the globalisation process. There should, however, be proper sequencing in the liberalisation process. Given the level of vulnerability of the economic and social institutions, the immediate application of multilateral international rules could curtail long-term development. African countries need to ensure that involvement in the global economy is consistent with their overall development objectives. This would require trading rules that promote rather than undermine economic opportunities. African trade is constrained by market imperfections that also explain the high cost of doing business. An overall coherent trade strategy with proper sequencing between building the relevant export base before further ambitious liberalisation on the import side is crucial (Doing Business in Africa, 2006).

If regionalism is to be a building block to openness to the rest of the world then African regional integration will need to address core trade and development problems. Regional integration needs to promote the convergence of macroeconomic policies that will help provide a more stable economic framework, and should involve a concerted effort to remove official and unofficial impediments to intraregional merchandise trade. In all subregions there are grounds for optimism. The institutional framework should include credible mechanisms that foster a healthy business environment.

Credibility may be reinforced with carefully negotiated additional commitments in bilateral or multilateral negotiations. Africa should take advantage of the Doha Development Agenda (DDA) negotiations to obtain better concessions. The second possibility is to make credible commitments within the framework of ongoing Economic Partnership Agreement (EPA) negotiations between the African regions and the European Union. The third possibility is to set regionally agreed targets in critical policy areas such as the NEPAD peer review mechanism or macroeconomic convergence criteria as these could reduce transaction costs, for example, the three members of SACU, namely, Lesotho, Namibia and Swaziland, have surrendered monetary policy to the South African Reserve Bank. This in turn protects their economies from speculative attacks on their currencies since their currencies are pegged to the rand and they benefit through the lowering of transaction costs as trade is carried out in rands (Guha-Khasnobis, 2004; Pearson, 2004; World Bank, 2005b; Bertelsmann & Draper, 2006).

#### **4.7.3 Addressing the core problem of competitiveness**

A significant constraint to African trade expansion is related to behind the border agenda issues that focus on infrastructure (soft and hard) and institutional deficiencies. There would also be a need to develop a regional framework in key policy areas such as investment and competition. The focus should be on three aspects, namely, trade facilitation, regulatory reform, and funding mechanisms (Diagne, 2005).

According to Diagne (2005) and Jebuni and Soludo (1995) the agenda on trade facilitation involves primarily the implementation of regional economic integration. Trade facilitation programmes focus on raising awareness among national and regional policymakers of the need to reduce transport costs in sub-Saharan Africa, and the ways in which effective policies may be devised to address this issue. The reduction of

transport costs could be achieved through the design and implementation of systematic regional/corridor data collection and management systems, thus making it possible to produce and disseminate reliable statistics on the cost efficiency of transport services along major regional corridors and for the principal commodities traded. Recurring bottlenecks, be they administrative, regulatory, informal or due to infrastructure shortcomings, would have to be identified and solved to improve the situation.

All RIAs have trade facilitation projects. The following is a selected list of regional projects in transport and trade facilitation to improve access of landlocked countries to export markets and thereby reduce trade costs and transit times: The West Africa Road Transport and Transit Programme; the East Africa Road Transport Programme, the Central Africa (CEMAC) Trade and Transport Facilitation Project, the West Africa Power Pool, the Southern Africa Power Pool, the West Africa Gas Pipeline, the Senegal River Basin Development, the Nile River Basin Development, the Regional WAEMU Communications Infrastructure Programme, the WAEMU Partial Risk Guarantee Facility, the African Trade Insurance Agency, the Southern Africa Productivity Programme in Agriculture, and the West Africa Productivity Programme in Agriculture. These projects and programmes are based on the NEPAD Short-term Action Plan priorities and the Africa Action Plan (AAP) (Hoekman & Njinkeu, 2006).

Diagne (2005) indicates the urgency of a regional Transit and Facilitation Agency in each of the African subregions. Such an agency could oversee the installation and the management of the material infrastructures and services necessary to ensure the smooth transit of goods in the region. While all countries would benefit from such an agency it would be of greater benefit to the landlocked countries, as this agency would definitely address transit-related problems.

The agency could also provide an excellent opportunity to consider previous decisions as yet not implemented but aimed at facilitating the transit of goods, which would include issues such as juxtaposed border posts, and the harmonisation of customs information processing systems. Regional trade facilitation committees that already exist in most regions could be generalised and their structures and operations harmonised (Jansen & Vennes, 2006:13; Wilson et al., 2004).

#### **4.7.4 Diversification of production structures**

According to Freund (2000), in order to diversify their economies there is a need for African countries to spend more resources on technical training, as well as research and development, in order to enhance innovation in the production of industrial goods. It would not be necessary to return to the era of the failed import substitution strategy as this strategy requires the erection of high tariff walls to protect infant industries. Since a number of African countries are signatories to the WTO agreements that seek to liberalise trade, they would not be allowed to increase tariffs beyond their current levels. The key to reviving Africa's trade is innovation. It is essential to find more creative ways to develop African exports.

#### **4.8 Conclusion**

Regional economic integration in the developing, as well as in the developed, world has produced mixed results. RIAs in the developed world, in particular the EU, have been successful in terms of intra-regional trade and sustained economic growth. This is evidenced by good infrastructure in all sectors of the economy, industrialisation, an expansion of GDP and the convergence of per capita GDP amongst the EU members. In South East Asia, the region has experimented with a loose integration model but, because their production structures complement each other, they have derived better results from RIAs and

hence intraregional trade within the region is above 40 per cent of total trade.

The better result for ASEAN may be attributed to an outward-oriented model of integration as opposed to an inward-looking model which emphasises the protection of infant industries indefinitely. The Latin American economic integration scheme has not been as successful as that of the EU and East Asia because Latin America prolonged the infant industry protection to the detriment of other industries. However Latin America has fared better than Africa, in particular, Sub-Saharan Africa. According to Njinkieu and Gitonga (2005) and Siggel (2005), despite efforts by African countries to liberalise their economies, the continent's share of global trade is a paltry two per cent (UNCTAD, 2007). Africa continues to rely on the export of primary products of which prices are volatile resulting in worsening terms of trade.

As highlighted in this chapter Africa's integration schemes are fraught with various problems such as overlapping membership, ambitious RIA projects with short timeframes, lack of industrialisation, infrastructural backlog and stringent non-tariff barriers that hinder trade across borders. In order for Africa to derive more benefits from RIAs, African countries will have to set up conditions conducive to on economic development instead of replicating EU market integration. The replication of EU integration without changing the structure of the economies will not have positive results but will rather lead to the disappointment of the population of the sub-continent who expect a better life from regional economic integration. African economic integration will only be successful once leadership shows a willingness to confront the sensitive question of sharing sovereignty with supranational institutions and shows political boldness in advancing a regional agenda.

## CHAPTER 5

### REGIONAL ECONOMIC INTEGRATION IN SOUTHERN AFRICA

#### 5.1 Introduction

In this chapter, an analysis of regional integration in Southern Africa will be undertaken by means of investigating the impact of regional economic integration on economic development and the improvement in the welfare of the populace. The greater part of the chapter will be devoted to the South Africa Development Community (SADC), of which all Southern African countries are members (McCarthy, 1994; Harvey, 2000; Keck, 2004). Furthermore, a position will be advanced that seeks to motivate the use of SACU as the nucleus of the new SADC Customs Union envisaged in 2010.

#### 5.2 Regional economic communities in Southern Africa

In discussing regional economic communities (RECs) in Southern Africa, the discussion will centre on the COMESA and SADC to highlight their structures and the developments in as far as deepening regional economic integration is concerned. Although SACU is also an REC in Southern Africa, it has already been discussed in detail in Chapter 4.

##### 5.2.1 The Common Market for Eastern and Southern Africa

According to Business Day (2007) the Common Market for Eastern and Southern Africa (COMESA), with twenty<sup>50</sup> (20) members, is the largest

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<sup>50</sup> COMESA members are Burundi, Comoros, Congo, Djibouti, Egypt, Eritrea, Ethiopia, Kenya, Libya, Madagascar, Malawi, Mauritius, Rwanda, Seychelles, Sudan, Swaziland, Uganda, Zambia and Zimbabwe.



REC in Africa. It comprises a population of about 400 million people and intra-regional trade has risen from US\$4 billion in 2001 to US\$9 billion in 2006. This represents approximately 10 per cent of the total trade of the region. It has been designated as one of the eight building blocks to the Africa Economic Community (AEC). COMESA formally came into being in December 1994 as a successor to the Preferential Trade Area (PTA) for Eastern and Southern Africa, which had been established in 1981. The establishment of COMESA was in fulfilment of the requirements of the PTA Treaty, which had provided for the transformation of the PTA into a common market ten years after entering into the PTA Treaty.

The COMESA Treaty of 1994 “seeks to promote joint development in all fields of economic activity and the adoption of common macroeconomic policies and programmes to raise the standard of living of all its peoples” (Common Market for Eastern and Southern Africa, 2006). The 1994 Treaty also outlines a framework aimed at achieving a customs union by 2004. This was subsequently revised to a new target date of 2008 (Common Market for Eastern and Southern Africa, 2006; Pearson, 2006).

COMESA’s primary instrument for deepening and broadening the integration process among its member states is the adoption of more comprehensive trade liberalisation and facilitation measures. Such measures include, but are not limited to, the elimination of tariff and non-tariff barriers to trade. Concrete objectives and achievements include the COMESA Free Trade Agreement (FTA) which now includes 11 members and was entered into in 2000 (The COMESA Treaty, 1994, Article 3(b)). The failure to achieve the planned milestones such as the launching of the customs union (as scheduled in (2004) may be attributed to the different levels of development within the region and possibly also to a lack of political will.

With the planned adoption of customs union by the end of 2008, COMESA envisaged a common external tariff (CET) with three broad bands set at 0–5 per cent (capital goods and raw materials), 10–15 per cent (intermediates) and 20–40 per cent (final goods). The substantial variation in the final goods target band reflects differences amongst the member states owing to different starting points and approaches to trade liberalisation. According to Bosire (2007:6) and Pearson (2004) the implementation of the CET remains problematic for several reasons, chief of which are fears over revenue loss arising from the adoption of CET. Furthermore there is also a fear amongst the potential members of the COMESA Customs Union over the loss of policy space to pursue infant industry protection. Countries continue to pursue hedging strategies to figure out the directions in which the different RECs in Southern Africa are heading, as member countries want to join the most beneficial REC.

Significant harmonisation work, as noted by Pearson (2004), has been undertaken towards the attainment of the customs union (CU) by 2008. The COMESA Secretariat has implemented a number of practical solutions, such as the COMESA Customs Document (COMESA-CD) to help in reducing the volume of documentation required to move goods within the region. Improvements in related areas could contribute substantially to increasing intra-regional trade. COMESA's revised draft Medium Term Strategic Plan (MTSP) for 2007 to 2011 outlines its integration targets.

Among the set goals is a revised roadmap to guide member states towards the achievement of a customs union by the end of 2008. Progress on the ground does indicate that the COMESA customs union will be launched as scheduled, albeit with fewer members (Economic Commission for Africa, 2007; Common Market for Eastern and Southern Africa, 2006). The members opting out for now have an opportunity to join at a future date, when their economies are ready.

### **5.2.1.1 Challenges of COMESA integration**

The gradual evolution to a CU by 2008 is being impeded by the poor state of domestic and inter-regional transport and communications structures, access to information on trade opportunities, and bottlenecks at border crossings. The other formidable challenge is the low level of intra-regional trade, currently at about 10 per cent of total trade, which indicates that COMESA member states trade with each other less than they do with non-members (Musila, 2005).

Low intra-regional trade is a common feature of all RECs in Africa as the continent trades more with non-African countries<sup>51</sup>. The low level of intra-regional trade may be attributed to the lack of complementarities in production structures manifesting in the overproduction of raw materials at the expense of finished goods. It may also be attributed to the geographical positioning of COMESA members given the problem of transport linkages between member states, which are compounded by high transportation costs on the African continent. Without innovation that will lead to the production of finished goods the trend of low intra-regional trade will continue, irrespective of whether tariffs are lowered to zero or not (Pearson, 2004 & 2006; Business day; 2007).

### **5.2.3 The South African Development Community**

The South Africa Development Coordinating Conference (SADCC), the predecessor of SADC, was formed in 1980 as a bulwark against apartheid South Africa and the aim of its existence was to pool regional resources so as to reduce the dependency of members on South Africa.

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<sup>51</sup>Africa's intra-regional trade is lagging at 5 per cent of its total trade. What may be observed is that the bulk of Africa's trade is with the EU, the US and Asia (in that order).

It was reformed in 1992 into SADC with the aim of focusing on regional economic integration. Southern Africa has experimented with a variety of integration initiatives, resonating with the 'new regionalism' wave that animated such projects worldwide in the 1980s and early 1990s (Africa Economic Commission, 2005; Schiff & Winters, 2003). The SADC block comprises fourteen member states: Angola, Botswana, Democratic Republic of Congo, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, South Africa, Swaziland, United Republic of Tanzania, Zambia and Zimbabwe (Economic Commission for Africa, 2005; SADC Today, 2006).

South Africa joined in 1994. The reformation of SADC in 1992 has institutionalised a market integration model, underpinned by a strong developmental agenda. This approach, premised on a developmental integration paradigm, reflects an understanding that a free market integration project, accompanied by a minimalist state participation, is highly inappropriate for a developing region such as SADC, a region in which the economies are characterised by deep structural disparities, socioeconomic rigidities and a lack of investment by the private sector. Developmental regionalism may thus only be catalysed by strong states that are institutionally effective, politically responsive, and efficiently regulated. In the absence of a developmental orientation vis-à-vis regional integration and regional governance it would be impossible to meet basic human needs and eradicate poverty, mitigate the existing disparities in the levels of development between SADC countries, and forge deeper, equitable, and mutually beneficial regional relations, as the SADC Treaty enjoins its members to do (Economic Commission for Africa, 2005; SADC Today, 2006).

SADC integration is skewed in nature in that it is centred on South Africa as the hub for trade, food, labour migration, investment and capital goods, and the rest of SADC can be likened to the spokes in the

wheel. The SADC Treaty (1992) lists the objectives of a regional integration project in Southern Africa as not only the removal of barriers to intra- and extra-regional trade flows but also as the principle advocated by development regionalism, which is to encompass a significant vision that promotes regional industrialisation, structural diversification, and sustainable human development and security (Tagg, 2001; SADC Report, 2006).

The SADC Regional Indicative Strategic Development Plan (RISDP), which was adopted by Heads of State and Government at the August 2003 Summit, is the blueprint for the SADC regional economic integration programme. According to RISDP (2003) the region seeks to consolidate and deepen regional economic integration beyond an FTA as envisaged by the SADC Trade Protocol (2000).

The RISDP reaffirmed milestones in facilitating the attainment of the SADC FTA by 2008, CU by 2010, Common Market in 2015, Monetary Union by 2016 and a single currency by 2018 in line with the Africa Economic Community schedule. In this plan, the effective implementation of a SADC FTA by 2008 would facilitate a smooth transition towards a SADC customs union (SADC Today, 2006).

### **5.3 Regional economic integration and economic development in Southern Africa**

According to the theory on regional integration, the formation of regional integration arrangements will foster economic development in the region. The success of regional economic integration in Southern Africa will be measured in terms of economic development, welfare enhancement, reduction of poverty and infrastructure development. The liberalisation of tariffs and removal of non-tariff barriers will increase

intra-regional and intra-industry trade. Economies of scale will result in lower transaction costs and the benefits of specialisation by regional industries. With all the publicity about regional economic integration in Southern Africa one realises that many of benefits that accrue to membership of RIA have not been achieved due to constraints such as overlapping membership and supply-side constraints, such as infrastructure development and the non-tariff barriers prevailing in various forms in Southern Africa. In meetings of all Southern African RECS, member states refuse to discuss or reveal their choice of REC as they have dubbed this 'a sovereignty issue'. However, taking refuge behind the sovereignty issue will only delay the deepening of regional economic integration in Southern Africa, for example, by not making a choice between COMESA, SADC and SACU; Swaziland will delay the realisation of the envisaged COMESA and SADC customs union by 2008 and 2010 respectively. This is also true of other member countries, with the exception of Mozambique which is affiliated only to SADC (SADC Today, 2006; SADC Report, 2006).

The lack of development agendas in RECs has led to a backlog of infrastructure and other common projects in the region. The low level of industrial development in the SADC region reflects in part the archaic state of infrastructure, which is not supportive to industrial strategies that that the region might want to pursue.

The projects that are exemplary in the region have been undertaken through bilateral agreements based on public-private partnerships<sup>52</sup> (PPPs). For example, the multibillion rand Maputo Development Project

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<sup>52</sup> PPP model refers assigning function(s) or an assignment to the private sector on behalf of the public sector. The private party arranges the funding necessary to meet the capital and other expenditure requirements of a project from its own balance sheet resources. Upon delivery, the state party assume payments to the private party over an agreed period (National Treasury PPP Unit, Standard PPP Provisions, March 2004).

could not have been realised without the financial backing of South Africa, which in turn resulted in guaranteed funding from, among others, the South African banks and development finance institutions such as Development Bank of Southern Africa and the International Financial Institution (World Bank). SADC still has to draw up the infrastructure master plan for the region and it appears that even this initiative is being fostered by the EU and the World Bank. The finalisation of the regional infrastructure master plan will not lead to the development of infrastructure unless funding is forthcoming from member states (SADC Today, 2006; SADC Report, 2006).

Currently, most of SADC projects are earmarked to be funded by international cooperating partners<sup>53</sup> (ICPs) as member states do not have the capacity (or are not willing) to contribute. SADC does not have a developmental fund to undertake socioeconomic development in the region. For the foreseeable future any attempt at infrastructure or industrial development in SADC will be undertaken through bilateral agreements between the countries concerned, as is the case with the Maputo Development Corridor between the RSA and Mozambique. The poverty in which the population of the region find themselves will need to be addressed through the creation of employment and the willingness on the part of governments to supply the welfare and social services which are at present largely non-existent (SADC Today, 2006). The success of an REC has always been judged in terms of the growing intra-regional or intra-industry trade. Despite the liberalisation of tariffs, to the extent that the average tariffs in the region are below 5 per cent, intra-regional trade has remained low (about 20% of SADC total trade) in SADC. These low levels of intra-industry trade may be attributed to a lack of complementarities in the production structures in the region (see Section 3.2.2). Furthermore, countries outside the

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<sup>53</sup> This refers to donors. The acronym ICP was coined at the Windhoek Summit in 2005, where SADC adopted guidelines for dealing with donors.

SADC are the major trading partners<sup>54</sup> of SADC member states, in which the primary commodities are inputs to the outputs of these countries (Economic Commission for Africa, 2005; Economic Research Bureau, 2007). The bulk of the goods traded are primary commodities and this reduces the opportunity for intra-regional trade. For example, if both Malawi and Zimbabwe produce maize and tobacco for export market, the result is that there will be minimal bilateral trade between the two countries since they produce similar goods. Even if the tariff lines between the two countries were to be reduced to zero, it is probable that the two-way trade between the two countries would not improve beyond the current levels.

With the exception of South Africa, which is an industrial economy (in comparison to all other African countries), the largest proportion of SADC exports is made up of primary commodities. Therefore, it is difficult to use the extent of intra-regional trade as a yardstick to measure the deepening of regional integration in Southern Africa. Irrespective of whether or not the FTA will be attained in 2008 (it is on track) intra-industry or intra-regional trade will not change significantly. This assertion is supported by the theoretical argument on regional integration, which states that greater efforts are needed to ensure that industries in Southern Africa complement each other (Economic Research Bureau, 2007).

SADC has definitely made progress in terms of solidarity. No matter how much the actions of a member state may be contrary to the good spirit of SADC, such member state is guaranteed the full support of other member states. The foundation of the current solidarity has to be found within the nature of SADC as an organisation. SADC has still not

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<sup>54</sup> The European Union, Asia (in particular China and India) and the US, in that order, are the major trading partners of SADC countries.



progressed beyond its inception as an intergovernmental institution formed in 1980 as a bulwark against an oppressive South Africa. Oppressive South Africa has since been replaced by all sorts of 'perceived enemies such as neo-colonialists and those that seek to derail economic development in the region so that they remain in control of its destiny. The move towards a regional economic community with greater emphasis on economic development has been somewhat slow and disappointing (Matlosa, 2005).

#### **5.4 The challenges of regional economic integration in Southern Africa**

The adoption of the SADC Trade Protocol in 2000, subsequently followed by the Regional Indicative Strategic Development Programme (RISDP) in 2003, has institutionalised developmental regionalism as a strategy to arrest under-development in the region. However, relatively low levels of intra-regional trade flows, ongoing protectionism and supply-side constraints, and a lack of political will on the part of many SADC members have cast doubt on the feasibility and attainability of the targets set. Many of the prerequisites that would ensure the benefits of market integration are obviously lacking in SADC, as they are elsewhere on the African continent. These conditions include:

- A similar level of industrial development among member countries;
- Harmonised national macroeconomic policies, as well as regional macroeconomic stability exemplified in the achievements of macroeconomic convergence targets;
- Significant intra-regional trade and complementary industrial development; and
- A politically stable region, with a willingness to cede some degree of sovereignty to a supranational body that has enforcement authority.

#### 5.4.1 Economic structure and trade patterns in Southern Africa

McCarthy (2004), Shams (2005) and Vickers (2006) note that South Africa is the largest economy in the region as it accounts for almost 76 per cent of the SADC GDP. The other countries in the region are fairly small, with each accounting for less than 5 per cent of the regional GDP. However, on a global scale South Africa (and Africa in general) is small compared to the other major trading partners of the region. A similar pattern holds true for exports in which South Africa is the major exporter among the SADC countries, but it is small on the global market when compared to the EU.

SADC countries are more dependent on trade than the EU<sup>55</sup>. The international trade share to GDP average 50 per cent of GDP for SADC countries. In contrast, the EU exports trade share to GDP amounts to 14 per cent of GDP. A similar pattern emerges for imports as a share of GDP. The high trade dependency means that trade liberalisation could induce large structural changes in Southern Africa. It is this which made SADC leaders see the potential of trade policies to change their economies to respond to the challenges of poverty and underdevelopment (SADC Today, 2006; Economic Research Bureau, 2007).

All SADC countries have engaged in significant reform of their tariff regimes in recent years. These reforms have generally resulted in the lowering of most favoured nation (MFN) rates and the adoption of a cascading structure of tariffs, according to which the lowest rates are applied to capital goods and raw materials, median rates are applied to intermediate goods, and the highest rates are applied to finished goods.

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<sup>55</sup> The comparison with the EU on trade dependency is made on the basis that the EU is SADC biggest trading partner.

Such tariff reductions are viewed as a necessary part of a broad restructuring process to make the region more competitive internationally. Tariff liberalisation enhances market access, allowing the entry of new firms, products and services into regional markets (McCarthy, 1994).

#### **5.4.1.1 Trade dependency in Southern Africa**

All SADC countries depend heavily on the EU for export sales. Botswana has the highest dependence and it sells 76 percent of its exports to the EU (primarily diamonds). Other SADC countries sell between 28 percent (for Zambia) and 39 percent (for Malawi and Mozambique) of their total exports to the EU. Despite its relatively low export dependence on the EU, Zambia depends on the EU for certain commodity sales – it sells 94 percent of its fruits and vegetables, 90 percent of its textiles, and 85 percent of its processed food to the EU. The other SADC countries also depend heavily on EU markets for the sale of their processed food, textile, apparel, and fruits and vegetables (USAID, 2007; Economic Commission for Africa, 2005).

SADC countries are less dependent on South Africa than on the EU as a market for their exports. The export shares to South Africa range from 0.4 percent for the rest of the SADC to 13 percent for both Botswana and Zimbabwe. With the exception of South Africa, which is an important destination for exports, there is little trade among the SADC countries. Zimbabwe is the next most important country in the region, after South Africa, as an export destination for all SADC countries. However, the export market shares to Zimbabwe are small, ranging from 0.2 percent for the rest of the SADC to 3.2 percent for Botswana (Economic Commission for Africa, 2005; SADC Today, 2006).

#### **5.4.1.2 Contrasting production structures in SADC**

According to the Africa Economic Commission (2005) and SADC Report (2006) there are significant differences in the production structures of SADC countries, as well as between the individual SADC countries and the EU, which is the biggest trading partner. With the exception of South Africa, primary products account for a higher percentage of most of SADC countries. Primary products of many of the countries in the region comprises a high proportion of their total exports – 69 percent for Malawi, 46 percent for Tanzania, 39 percent for Zimbabwe, and 18 percent for Mozambique agricultural products such as grains, fruits and vegetables, livestock, forestry and fisheries account for as much as 31 per cent of the value of output in Tanzania, 29 per cent in Malawi, and 24 per cent in Mozambique (Economic Research Bureau, 2007; United States Agency on International Development, 2007).

In contrast, primary products account for only four percent of the value of output in South Africa, while in the EU primary products account for only three per cent of the value of output. Food processing is also an important sector for many of the SADC economies (11% each). Mining is an important sector for Botswana, as it accounts for 28% of its GDP and 21%, for the rest of SADC.

As for capital such as machinery and equipment production, this comprises a low share of the output of many of the SADC countries with the extreme example being Mozambique (0.7% of the value of total output) (Pettersson, 2005; Economic Research Bureau, 2007; United States Agency on International Development, 2007).

### **5.4.1.3 The extent of protectionism in trade**

According to the Economic Research Bureau (2007) and the SADC Report (2006) import protection rates vary considerably by sector and source of imports. South Africa protects apparel (with rates varying from 31% against the rest of SADC to 13% against Mozambique), textiles (ranging from 20% against Malawi to 10% against the rest of SADC) and food processing (ranging from 100% against Malawi to 49% against Tanzania). South Africa has a high trade weighted average tariff against Malawi (21%), Tanzania (20%), and Mozambique (19%). Its average tariffs against other SADC countries range from 0 to 10 per cent. It also has a relatively low average tariff against the EU at eight percent. However, in certain sectors, the tariff rates against EU imports are fairly high: 71 percent for food processing, 39 percent for grain, 26 percent for apparel and 26 per cent for fruits and vegetables.

With the exception of Botswana and South Africa, which have both eliminated bilateral tariffs, intra-SADC tariff rates are high and uneven across countries in the region. The highest average tariff rate against another SADC country ranges from 94 percent (Zimbabwe against certain category of imports from Tanzania) to 20 percent (Zambia against imports from Malawi). Zimbabwe has the highest average tariff rates against other SADC countries, ranging from 12 percent against imports from Malawi to 94 percent against imports from Tanzania (Petersson, 2005; Economic Research Bureau, 2007).

### **5.4.2 Poverty and inequality in Southern Africa**

Thus far, regional economic integration in Southern Africa has yielded few social and economic dividends. Over the last four years, the majority of countries within SADC have experienced reversals in many Millennium Development Goal (MDG) indicators, which is a key

measurement criterion for success in halving poverty by 2014<sup>56</sup>. Poverty and unemployment remain a common problem for the population of Southern Africa. The majority of the problems may be attributed to the populist policies pursued by governments, for example, Zimbabwe continues to pursue indigenisation<sup>57</sup> policies that have the potential to reduce the majority of the population to abject poverty. Furthermore, natural calamities such as drought and floods continue to wreck havoc in the farming communities exacerbating the shortage of basic foodstuffs. Poor management of water resources and lack of water infrastructure such as dams and irrigation schemes have contributed to shortage of food (Petersson, 2005; Southern Africa Development Community Report, 2006).

Even South Africa, which is the biggest economy (in terms of output) in the region, has poverty levels (especially in rural and peri-urban centres) that are not commensurate with her level of economic development. The inequality in South Africa between the rich and the poor, as measured by the Gini Coefficient, is currently one of the highest in the world, at 0.64 and is comparable only to that of Brazil (Economic Commission for Africa, 2007). The success of the SADC regional project is, moreover, confounded by a myriad of political, economic, security and institutional pressures and variables, both internal and external to the region. These include the impact of foreign competitive pressures, notably from the Chinese and on the vulnerable economies and underdeveloped industrial structures of the region, which are in turn balanced by a bullish commodity cycle that has seen significant windfalls for other minerals-based economies (SADC Today,

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<sup>56</sup> Poverty datum is measured in terms of ability to afford basic needs, especially for those whose disposable income is less than one US dollar per day.

<sup>57</sup> The indigenous policy refers to government stated policy aimed at forcing the private sector to give a substantial share (up to 50 per cent) of their equity to indigenous population (read black). In the Zimbabwean situation the policy is controversial in that the receiver will not pay for equity they receive and that the economy situation cannot sustain such a policy.

2006). Although the eradication of poverty has been identified as a priority for SADC, the reality on the ground reveals that the region is still a long way from addressing the problem, or meeting the Millennium Development Goal target of halving poverty by 2014.

### **5.4.3 Different developmental paths of member states**

This integration project has been further complicated by the fact that the SACU nations, led by South Africa has forged trade relations with the EU and EFTA, as well as recently concluding a Trade and Investment Cooperation Agreement with the US (leading to an FTA in the future to 'lock in' AGOA<sup>58</sup> market access) There is even the vision of a trilateral trading arrangement between India, Brazil and South Africa (IBSA). In addition to these dynamics, there is great concern about the direction of the post-Cotonou EPA negotiations with the EU and their effect on regional solidarity and regional integration, as envisaged by the Abuja Treaty (Pearson, 2006; SADC Report, 2006; UNCTAD, 2007).

In the case of SADC, the effects of external actors on the regional integration process are of particular importance. The overall SADC market is not large enough to achieve the growth objectives of its members. This has spurred SADC to actively engage external actors such as international cooperation partners (ICPs), the EU, the US, China and MERCOSUR, whose attached conditions (for cooperation) are often detrimental to the developmental agenda of Southern Africa.

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<sup>58</sup> AGOA stand for the Africa Growth and Opportunity Act of 2000. It is an agreement between the US and Sub-Saharan African countries whereby the latter are given preferential access to the US market once they have demonstrated significant progress in political and economic governance.

#### **5.4.4 SACU challenges in the face of the SADC Customs Union**

SADC Today (2006:6) and the Economic Commission for Africa (2005:46) argue that SACU is currently facing global and regional developments that have serious implications for its work activities in the medium term. SACU recognises the unfolding regional development process of the Southern African Development Community (SADC) and the projected formation of the SADC FTA by 2008, as well as the establishment of the SADC Customs Union by 2010. It has been noted by SACU members that the attainment of the full SADC FTA by 2008 and the projected SADC Customs Union would have an impact on the different member states of SACU. SACU's problem is further compounded by the resolution of the AU which does not recognise SACU in the REC rationalisation towards the establishment of the Africa Economic Community. SACU is therefore cognisant of the call for its demise and has devised a way of dealing proactively with the process of consolidation (read Southern Africa Customs Union Treaty, 2002) to postpone its demise (McCarthy, 2004; Vickers, 2006).

With regard to developments related to the SADC customs union, SACU has indicated its willingness to provide inputs into this process and to articulate its position on the proposed SADC Customs Union. The general feeling among SACU members (in particular, Namibia, Lesotho and Swaziland) is that SACU provides financial benefits that contribute to a large proportion of their budget and, before any agreement to dissolve SACU is reached, they must be guaranteed that they will be compensated for these SACU transfer payments. On the other hand, South Africa has indicated that it will ensure that any future SADC customs union configuration will exclude the revenue sharing arrangement in its current form, which is not linked to economic performance of member countries (Vickers, 2006; Economic Research Bureau, 2007).



With the exclusion of Botswana, which does not overly depend on the SACU transfers, the other members agree that SACU is an institution with fine traditions and should be the nucleus of the SADC Customs Union to which new members may accede through variable geometry (SADC Report, 2006; Economic Research Bureau, 2007). With variable geometry, differentiated integration is pursued whereby countries join when they have already undergone the adjustment process taking into consideration the aspect of asymmetry in development. In SADC, with SACU as the nucleus of the new SADC customs union, the five current SACU members will automatically qualify based on their similar policies such as macroeconomic convergence, the common external policies and other policies inherent in customs union. The new members will have to adjust to the policies whilst making sure that they don't come out worse-off. This is in contrast to the findings of the Study on SADC customs union which concluded that the envisaged SADC union should be inclusive for all 14 SADC members irrespective of their stage of economic development (Economic Research Bureau, 2007).

#### **5.4.5 Progress with the launch of SADC Free Trade Area in 2008**

The SADC Protocol on Trade (2000) commits the signatories to the establishment of an FTA. After extensive negotiations through 1996 to 2000, member states agreed on a series of tariff phase-down schedules that would result in 85 per cent of all intra-SADC trade being duty free by 2008, with the remaining 15 per cent, consisting of sensitive products, being liberalised by 2012. Four countries, namely, Malawi, Mozambique, Zimbabwe, and Tanzania were found to be behind in their implementation schedules. The recent report has indicated that the four countries are again on schedule. Five countries have heavily backloaded<sup>59</sup> their offers and will have to remove tariffs on a significant

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<sup>59</sup>This is a method of tariff liberalisation, which allow for a country to reduce gradually, starting at a low pace and reducing significantly at the end, for example, if a country is

number of lines in 2008 (Malawi 50%, Mozambique 64%, Tanzania 69%, Zambia 56%, Zimbabwe 26%). An audit study on the implementation of the SADC Trade Protocol has revealed the following (Economic Research Bureau, 2007; USAID, 2007):

- The Democratic Republic of Congo has not acceded to the Trade Protocol whilst Angola has not yet submitted its tariff reduction schedule. This implies significant adjustment costs for these countries if they have to be on schedule. South Africa/SACU and Mauritius are up to date with their implementation schedules.
- The study further reveals that, outside of SACU, an increasing amount of intra-regional trade is taking place under COMESA or under revived bilateral agreements. There has been a small increase in trade with SACU, for instance, in clothing from Mauritius and in the regional sugar trade under the Sugar Protocol. The audit recognised that some degree of progress had been made in adopting more flexible Rules of Origin, and harmonising and improving trade facilitation measures.

Given the time constraint faced by countries that still have to backload their tariffs before August 2008 (when the FTA is due to be launched), it is unlikely that they will achieve the feat.

For SADC to move forward, in particular countries that have already implemented the SADC Trade Protocol, a variable geometry strategy should be adopted where qualifying countries can form an FTA, and the rest join when they are ready. If SADC member countries are not agreeable to the variable geometry strategy, it is unlikely that SADC will

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required to reduce 80% of its tariff within a period of five years, it can reduce half the amount in the first three years and the rest in a shorter period, in this case, half. This is done to allow countries to adjust and in many cases to build other sources of revenue that will replace the revenue derived from import taxes.

be able to launch an inclusive FTA as scheduled given the tariff reduction backlog that some countries are facing.

## **5.5 Gains in regional economic integration in Southern Africa**

### **5.5.1 Macroeconomic convergence in SADC**

According to the Economic Research Bureau (2007:12), McCarthy (2002:8) and Mboweni (2003), a significant level of macroeconomic convergence is necessary in order to achieve the policy objectives of regional integration. SADC is currently in the first phase of market integration and, if the road to the progressive deepening of integration is taken into account, monetary integration will be an important development. The integration of the money and capital markets will lower the transaction costs of regional trade and will increase the efficiency of capital allocation in SADC.

The SADC Memorandum of Understanding (MOU) on macroeconomic convergence sets out modalities, principles, institutional arrangements, monitoring and surveillance mechanisms, indicators/criteria, data requirements, and monetary and fiscal policy cooperation parameters for the member countries. Chapter 2 advanced the argument in favour of adopting few macroeconomic targets that are commensurate with the level of economic development. There is no deviation from that argument as this section seeks to analyse the current situation of macroeconomic convergence in SADC (McCarthy, 2002).

Macroeconomic convergence in SADC is premised on the recognition by member countries of the need for financial and economic stability, soundness of institutional structures and policy frameworks. This is deemed critical in achieving fiscal balances that avoid the monetisation

of deficits, unsustainably high or rising ratios of public debt to GDP, wide external current account and financial imbalances, and market distortions resulting in high rates of inflation and a slow pace of economic development amongst SADC member countries. There is an understanding that, in preparation for the higher stages of integration, there is a need for the region to converge on key market indicators informed by the level of development in the region (Southern Africa Development Community Report, 2006; Committee of Central Bank Governors Report, 2007).

Every year the national economic data collecting agencies, such as Statistics South Africa and the Reserve Bank (in the case of South Africa), submit the macroeconomic data to the Committee of Central Bank Governors (CCBG) to compile a paper on macroeconomic developments in the region which is then published annually on the websites of the SADC Central Banks (McCarthy, 2002; SADC Today, 2006; FOPRISA, 2007).

Member states have further agreed to establish the Macroeconomic Surveillance Unit and the Peer Review Panel to review progress by member countries in meeting the targets and to offer guidance to any member states that may be deviating or struggling to meet the targets through no fault of their own, that is, when the underlying factors are global or natural<sup>60</sup> (Southern Africa Development Community Report, 2006).

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<sup>60</sup> Global influences on macroeconomic indicators are issues that are beyond the control of the member state or the region. These include factors such as rising oil prices whereas natural calamities are factors that are beyond the control of mankind and include drought, tsunamis, etc

McCarthy (2002), the Economic Research Bureau (2007) and Mboweni (2003) all emphasise that macroeconomic convergence in the SADC region is guided by the criteria and benchmarks that have been specified by a Committee of Central Bank Governors (CCBG). These focus on the key essential requirements for macroeconomic convergence: inflation rate to reach single digits by 2008; 5 per cent by 2012; and 3 per cent by 2018; the ratio of budget deficit to GDP should not exceed 5 per cent by 2008, and 3 per cent by 2012 through to 2018; and the nominal public debt to GDP ratio should be less than 60 per cent by 2008 and beyond to 2018.

Table 5.1 illustrates the level of convergence/divergence between member states in 2005/2006<sup>61</sup> compared with the targets of the SADC Macroeconomic Convergence Programme.

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<sup>61</sup> The paper on the macroeconomic performance of member states for 2007/8 is still under compilation.

**Table 5.1: Status of macroeconomic convergence in 2005 and 2006**

Country	Inflation rate		Budget deficit (-) / surplus (+) as percentage of GDP		Public debt as percentage of GDP		Current account as percentage of GDP		Real growth rate	
	2005	2006	2005	2006	2005	2006	2005	2006	2005	2006
Angola	18.5	12.2	7.3	-3.4	37.8	25.5	15.7	16.4	20.6	19.5
Botswana	8.6	11.6	1.2	8.1	4.4	3.8	15.7	20.9	9.2	-0.8
DRC	21.3	18.2	-1.2	-0.7	158.7	133.4	-4.4	-7.5	6.5	5.1
Lesotho	3.5	6.0	2.0	13.3	50.3	49.9	-6.8	4.3	4.0	6.2
Madagascar	18.4	10.8	-10.3	-10.3	87.0	30.0	10.9	-8.8	4.6	4.9
Malawi	15.4	13.9	-1.2	-1.5	105.4	28.5	-34.0	-31.2	2.3	
Mauritius	4.9	8.9	-5.0	-5.3	58.3	57.9	-5.2	-9.5	2.2	5.0
Mozambique	6.4	13.2	-3.5	-1.0	70.0	47.7	-11.09	-8.0	6.2	8.5
Namibia	2.2	5.1	-1.1	2.1	33.6	31.4	7.1	18.3	4.2	4.6
South Africa	3.9	4.6	-0.8	0.04	36.6	33.3	-3.8	-6.4	5.1	5.0
Swaziland	4.8	5.3	-1.8	-2.1	16.9	17.1	0.26	1.8	2.3	2.8
Tanzania	4.4	6.2	5.0	-5.5	63.8	49.97	-6.9	-10.9	6.7	6.2
Zambia	15.9	8.2	-2.6	-1.9	64.5	25.8	-11.8	-1.2	5.2	5.8
Zimbabwe	585.8	1281.8	-3.5	-5.5	110.2	76.2	-12.0	-7.9	-3.8	-1.8
SADC – Zim	9.9	9.6	-0.9	-0.6	60.6	41.1	-4.3	-1.7	6.1	6.3
SADC(All Average)	51.0	100.4	-1.1	-1.0	64.1	43.6	-4.9	-2.1	5.4	5.7
Convergence Criteria (2004-08)	single digit inflation rate by 2008		less than 5% by 2008		less than 60% of GDP		Less than -9% of GDP		not less than 7%	

Source: The Committee of Central Bank Governors 2007

With reference to Table 5.1, when comparing the 2005/6 ratios with SADC convergence targets review for 2008, the Committee of Central Bank Governors (CCBG) concluded that:

- With regard to the attainment of convergence targets, SADC member states as a group recorded mixed performances.
- The number of countries with single-digit inflation declined from eight to seven in 2006 .The projection from the interim report<sup>62</sup>

<sup>62</sup> The final report on macroeconomic convergence by the Committee of Central Bank Governors will be launched at the SADC Heads of State and Government Summit in August 2008.

for 2007/8 by the Committee of Central Bank Governors highlights regression in member states, especially in meeting the inflation target. This has been attributed to the global food and oil prices that feed into the Consumer Price Index minus mortgages, which is used to measure inflation in SADC economies. For example, South Africa which has been a flag bearer on low inflation has recently seen its targeted inflation breaching the targeted range of 3-6%. Although inflation in South Africa is still within the single digit range at about nine per cent, it is by far above the target set by monetary authorities in South Africa. The situation in other SADC countries is not any better, as they will be unable to attain single digit inflation as per SADC targets.

- Certain SADC countries, in particular, Malawi and Mozambique, are making significant progress in reaching their 2007 single-digit inflation projections.
- The average budget deficit for the SADC region is expected to increase in 2007 to 3.4 per cent of GDP.
- If Zimbabwe is excluded from the regional average, the deficit is projected to widen from 0.6 per cent of GDP (2006) to 2.0 per cent in 2007. Budget balances are expected to improve for Swaziland, Angola, DRC, Mauritius, Zambia and South Africa. The outlook for 2007 indicates that the SADC countries will do well, but not as well as in 2006.

In compiling SADC regional statistics, the availability of data remains a problem, especially in countries that do not publish their national accounts data by the end of the year when an analysis of Convergence Criteria is compiled. In addition, there are anomalies in the statistics provided by national institutions such as central banks and statistics offices. The harmonisation of data collection tools and interpretation of data will help to alleviate the problem (CCBG, 2007; FOPRISA, 2007).

### **5.5.2 Foreign direct investment in Southern Africa**

According to Kolala (2000), Tagg (2001) and UNCTAD (2007), foreign direct investment (FDI) is a cross-border investment made by an investor with a view to establishing a lasting interest in an enterprise and exerting a degree of influence on the operations of that enterprise. The foreign investor will hold an interest of at least 10 per cent in equity capital. The attraction of FDI remains one of the salient features of regional economic integration. In Southern Africa, local investment is insufficient for the fulfilment of the developmental challenges faced by the region. FDI is seen as a lead driver for economic growth and economic development. It has been indicated that regional economic integration enhances cross-border investment as well as FDI.

FDI may contribute positively to GDP, gross fixed capital formation (total investment in a host economy) and the balance of payments. There is a positive correlation between higher GDP and FDI inflows, however, this link does not hold for all regions. FDI may also contribute to debt servicing repayment, stimulate export markets and produce foreign exchange revenue. FDI, where it generates and expands businesses, may help stimulate employment, raise wages and replace declining market sectors. However, the impact of FDI will depend largely on the condition of the host economy, for example the level of domestic investment, saving, the mode of entry (whether it be a merger and acquisition or the setting up of a new firm) and the sector involved, as well as the ability of the country concerned to regulate foreign investment.

With respect to SADC countries, the main factors preventing an increased inflow of FDI are that most countries are regarded as high risk and are characterised by a lack of political and institutional stability



and predictability (Doing Business in Africa, 2006; UNCTAD, 2007). The status of FDI in SADC will be now analysed per country.

#### **5.5.2.1 South Africa**

Doing Business in Africa (2006) and UNCTAD (2007) confirm that South Africa is the largest contributor of intra-SADC investment as it accounts for 95 per cent of these investments. The economic policy strategies currently pursued in SADC countries are intended explicitly to improve conditions for FDI. The present analysis of the performance of the region shows that the SADC share of global FDI flows is very small. The region faces challenges as a result of weaknesses in its individual member countries. Even South Africa, which is relatively developed and rich compared to other SADC countries, attracts considerably less FDI than anticipated, and this despite the explicitly investor-friendly macroeconomic policy framework that is in place. FDI inflow into the region is predominantly in resources. This will become evident in the analyses of Angola and the Democratic Republic of Congo.

#### **5.5.2.2 Angola**

Angola has attracted huge amounts of FDI in recent years, although inflows have been volatile. This FDI consists largely of investments in the oil and natural gas sector. The oil sector accounts for more than 50 per cent of GDP, 75 per cent of government revenue, and 90 per cent of exports. Angola accumulated US\$5.4 billion in foreign currency in 2006 and, according to a report from the UNCTAD (2007), was one of the countries that contributed most to increase reserves and investment in sub-Saharan Africa.

The report showed that foreign currency reserves in the region rose by US\$33 billion. The report further noted that Angola and Nigeria, along with the group of oil producing countries, have been the main

beneficiaries of a strong increase in FDI, (approximately 43.5% increase on the previous year) to US\$18.5 billion. Angola was the second largest recipient in sub-Saharan Africa with over \$2 billion in 2004. In Angola, FDI rose by more than 100% from US \$304 million to US \$1650 in 2002 (IMF, 2007; UNCTAD, 2007).

**Table 5.2: FDI flows in SADC, 1997-2005 (in US\$ millions)**

Country	1992-1997	1998	1999	2000	2001	2002	2003	2002-2005
Angola	304	1.114	2471	879	2,146	1,643	1,415	1650,5
Botswana	-10	96	37	57	31	405	86	389,6
DRC	-6	61	11	23	82	117	158	408,5
Lesotho	25	27	33	31	28	27	42	42,3
Madagascar	13	16	58	69	84	8	50	51,1
Malawi	10	12	59	26	19	6	23	3,0
Mauritius	27	12	49	277	32	33	70	33,1
Mozambique	46	235	382	139	255	155	337	259,1
Namibia	106	77	20	186	365	181	84	226,4
South Africa	1045	561	1,502	888	6,789	757	762	2167,3
Swaziland	45	109	100	91	51	47	44	18,9
United Republic of Tanzania	90	172	542	282	467	240	248	475,0
Zambia	93	198	163	122	72	82	100	188,0
Zimbabwe	72	444	59	23	4	26	20	35,3
Total	1,860	3.134	5,486	3,093	10,425	3,727	3,439	3,908

Source: Doing Business in Africa 2006

The available data indicate that the experience of SADC countries in attracting long term capital flows has been mixed. Table 5.2 provides data on FDI to SADC in (US\$ millions) terms. As depicted, the inflows of FDI into SADC have been dominated by Angola and South Africa. While the oil and natural gas sector has been the main destination of FDI in Angola, South Africa has attracted foreign investment across a broad range of economic sectors.

### **5.5.2.3 Botswana**

According to International Monetary Fund (2007) significant amounts of FDI have been attracted to Botswana in the diamond mining and banking services. While incentive schemes have been important for these sectors other factors have also bolstered FDI. Among these are the stable political environment in Botswana, a stable macroeconomic policy and competitive exchange rates relative to the South African rand. Low levels of crime and good human capital development also make Botswana an attractive investment destination. This has resulted in Botswana graduating from least-developed country status to a middle-income country and Botswana was rated as one of the frontrunners with high FDI potential. However, despite the existence of a more conducive environment in Botswana, FDI has been low in comparison to other SADC countries, but the growth of FDI has been quite significant during the ten year period, 1992 to 2002.

### **5.5.2.4 The Democratic Republic of Congo**

During the period 2000 to 2005<sup>63</sup> the Democratic Republic of Congo witnessed an increasing flow of FDI, chiefly in the mining sector. The

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<sup>63</sup> The table does not include an infrastructure investment amount of 7, 5 US\$ billion from China in the beginning of 2008. If included, the DRC will have outperformed all countries in the SADC region in terms of attracting foreign direct investment.

continuation of the relative stability in the country will further increase the positive outlook for that country (UNCTAD, 2007).

#### **5.5.2.5 Lesotho**

Lesotho has made significant progress in attracting FDI. The remarkably good performance of the textile and clothing industry has been stimulated by FDI from the Far East, in particular, China and Taiwan. This followed the designation of Lesotho by the US as one of the beneficiary countries of AGOA, which allows duty and quota-free access for textile exports into that country until 2015. Infrastructure projects may also be the reason for most of the substantial inflows into Lesotho, particularly the Lesotho Highland Water project, which is a long-term venture between Lesotho and South Africa. However there have also been inflows as a result of privatisation and manufacturing investment.

Lesotho had surpassed most LDCs in attracting FDI – predominantly export-oriented and in significant amounts to the apparel industry. This has generated employment and foreign exchange. However, this FDI was dependent on temporary trade privileges, and Lesotho has to face the challenge of full global competition once these trade privileges expire (Doing Business in Africa, 2006; IMF, 2007).

#### **5.5.2.6 Madagascar**

According to the International Monetary Fund (2007) foreign direct investment in Madagascar has increased steadily since the early nineties, with overall inflows totalling US\$ 50 million in 2005. Estimates for 2006 suggest that inflows will amount to over US\$ 80 million. Most FDI originates from France, Mauritius, China, the US, India, Switzerland

and Sri Lanka. In 2004 the total assets of foreign companies amounted to approximately US\$ 3 billion.

The primary sector receiving investments includes textile and apparel, in which Madagascar has seen an increase of Asian investment. In order to develop its full FDI potential the government of Madagascar is continuing to improve the investment climate of the country, as is evidenced by the current efforts to revise the investment code and to create an investment promotion agency.

#### **5.5.2.7 Malawi**

Foreign direct investment in Malawi has increased from US\$ 28.9 million in 2004 to US\$ 52.0 million in 2005. According to UNCTAD (2007), inward investment in 2005 generated employment opportunities for approximately 5700 people. Most of the FDI inflows recorded in 2005 were in the form of new investments and there was very little investment in the form of mergers and acquisitions or the expansion of existing investments. Both domestic investment and FDI inflows into Malawi are expected to continue on the upward trend. This may be attributed largely to the further consolidation of prudent macroeconomic policies as well as other policy and structural reforms undertaken by government. All these initiatives form part of the broader policy context of private sector development aimed at creating a competitive economy that is both production and export oriented.

During the last quarter of 2005, the Malawi Investment Promotion Agency (MIPA) initiated a review of the Statement of Investment Policy and investment incentives. This initiative aimed at updating policy in order to make it more relevant to the current economic development agenda. In addressing the uncompetitive elements within the current

investment environment the review will improve Malawi's competitiveness relative to the region as an attractive environment for doing business and making investments. Besides reviewing the policy, the Investment Promotion Act (1991) will be updated to reflect the changes in the policy.

In the past few years investment promotion activities have been greatly affected by the delays in the implementation of the merger of the Malawi Investment Promotion Agency (MIPA) and the Malawi Export Promotion Council (MEPC). Government had signalled its commitment to conclude the MIPA/MEPC merger during 2006. This was a welcome development, as it enabled the successor institution to refocus its approach and to undertake effective investment promotion for Malawi (Doing Business in Africa, 2006).

#### **5.5.2.8 Mozambique**

The relatively high levels of investment in Mozambique in the late 1990s are, in part, due a number of successful mega projects. The establishment of the Mozal Aluminium smelter attracted US\$1.3 billion of foreign investment. Also investment in the Maputo Corridor transport and related infrastructure is specifically intended to act as a catalyst for further foreign direct investment (Jansen & Vennes, 2005; UNCTAD, 2007).

#### **5.5.2.9 Namibia**

Namibia has always been able to attract substantial FDI flows, ranging from slightly less than US \$106 million in 1992 to over US\$226.4 million by 2002. The total FDI in Namibia as a percentage of GDP increased from 17.8 percent in 1998 to over 25 percent in 2004. This is high when

compared to neighbouring countries such as South Africa, Swaziland, Zimbabwe and Zambia, but is below that of Botswana. FDI may still be considered as a cornerstone of economic development in Namibia. The recent investment opportunities offered by the Malaysia Textile Company, RAMATEX and the Scorpion Zinc Mine show the attraction in terms of the incentives and policies offered by the government in providing an environment conducive for increased FDI (IMF, 2007; UNCTAD, 2007).

#### **5.5.2.10 SADC is not receiving adequate FDI**

The FDI picture for Southern Africa indicates that the region is not receiving sufficient FDI flows to arrest underdevelopment. In the final analysis what is important for investors is a good rate of return on investment more than the prevailing security conditions of the country. At present resources command more interest as their prices are high and this guarantees a good return on investment. This is the reason why Angola, which has recently emerged from a civil war, attracts more investment than Namibia, which has been stable since independence in 1990. Since there is no alternative to FDI as a vehicle for economic development, Southern Africa should continue to create conditions that are attractive for FDI.

### **5.6 The role of SACU in regional economic integration in Southern Africa**

According to Jansen and Vennes (2006) and Masson and Pattillo (2005) RECs in Southern Africa have to rationalise in line with the AU moratorium. Although SACU is not recognised as a building block for the attainment of the Africa Economic Community (AEC), it is the oldest and a relatively successful customs union. The first step for SACU leaders is to market it at the African Union level so that its status is recognised as a building block to the AEC. SACU leaders believe that

the union is able to reinvent itself so that it may form the nucleus for the projected SADC customs union. This reinvention includes harmonisation of trade facilitation measures (customs, standards, documentation) and the proper establishment of those institutions provided for in terms of the 2002 agreement. Furthermore, a development fund should be set up to replace the volatile and contentious portion which is based on customs revenue and intra-SACU trade (McCarthy, 2004; SADC Today, 2006).

The political leaders need to back SACU as the core of a variable geometry option upon which a SADC customs union could be based. In order to achieve this SACU member states should embark on concerted diplomatic efforts targeting key 'swing states' such as Mozambique (which belongs to the SADC only) with an interest in joining SACU as a prelude to the mooted SADC customs union. As things stand, Mozambique is negotiating the European Partnership Agreement with the SACU group and this is the first step to harmonising its common external tariff and other policies with the SACU members. Given the residual suspicions of South Africa's motives, the BLNS would have to put aside their narrow self-interests and collaborate with South Africa (McCarthy, 2004; Economic Research Bureau, 2007; Business Day, 2008).

In 2007, SACU member states initiated a study whose finding provides an empirical analysis of the potential economic and developmental impact of the attainment of the SADC FTA and the projected SADC Customs Union on each member state of the SACU. The study assumed the SACU will be used as a nucleus for the SADC Customs Union and that additional members will be accede to the Southern Africa Customs Union Treaty (Economic Research Bureau, 2007; FOPRISA, 2007; Southern Africa Development Community Report, 2006).



Even with talks of the SADC customs union envisaged in 2010, SACU will continue to exist in years to come, albeit in a possibly expanded format. The current SADC configuration will make it highly unlikely for its graduation into a customs union. This can be attributed to overlapping membership among SADC members with other regional economic communities in South Africa, in particular COMESA and EAC. In this scenario, Tanzania can be excluded from the SADC customs union as it is a member of EAC customs union. In anticipation of COMESA customs union by end 2008, non SACU SADC members such as Angola, DRC, Malawi, Madagascar, Mauritius, Zambia, Zimbabwe will have to decide sooner, whether to form part of the COMESA customs union or withdraw their commitment to SADC customs union which an unknown entity. COMESA offers the best market for countries aiming to diversify their market beyond primary commodities as the SACU region is a de facto captive market for South Africa (SADC Report, 2006; SADC Today, 2006; Economic Commission for Africa, 2007).

A desirable situation would be one in which SADC members were to indicate which customs union they wished to join. At present, a serious debate at Summit of Heads of State and Government level or at a Council of Ministers should result in other SADC members disengaging from the projected SADC Customs Union in 2010 in favour of the COMESA and the EAC. The current SACU members could be expected to form the backbone of the new SADC Customs Union and might possibly be joined by Mozambique. This would depend on the review of the revenue sharing formula and whether the current SACU member states agree to it. At present SADC member states remain non-committal and indecisive with regard to the SADC Customs Union and this will delay any serious undertaking regarding the SADC Customs Union. Whatever outcome is achieved with regard to consolidation of regional economic integration in Southern Africa, each REC must remain open to new membership as long as the potential member is

open to adhere by the rules of the REC it wishes to join. For example, a member state that intends to join SACU must abide by the rules as stipulated in the SACU Treaty of 2002 (McCarthy, 2004).

If South Africa has its way the SACU institutions could be retained without the revenue sharing arrangement, but this could be blocked by the other four members whose interest in the SACU is solely as a result of this kind of arrangement, in terms of which they are guaranteed quarterly payments irrespective of the conditions prevailing in their economies. This arrangement has lasted for almost a hundred years and will not disappear easily. The old arrangement worked for the benefit of its members. The new arrangement is also bringing about benefits for its members. Another important fact is that South Africa is a major player in the region from both a trade and investment perspective (USAID, 2007).

## **5.7 RSA Position on SADC economic Integration**

South Africa's position on the rationalisation process of regional economic integration in Southern Africa is important since South Africa is the biggest economy and is the most likely to be affected by the process. South Africa's position on SADC integration is that the South African Custom Union (SACU) should form the nucleus of the new SADC Customs Union which SADC members will join through variable geometry<sup>64</sup>. This view has been pitched to the BNLS states on the expectation that SACU members would articulate this position together in SADC forums, but so far it has not gained momentum. South Africa

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<sup>64</sup> Variable geometry means that member states may only join the new SADC Customs Union once they have fulfilled the conditions set, such as liberalisation of tariffs, removal of non-tariff barriers and other conditions as set out by an agreement/treaty which was discussed in detail in Section 5.4.

has also refrained from engaging other SADC member states for fear of being labelled divisive. It must also be borne in mind that South Africa is new to SADC matters.

Of all the SACU members Botswana has not accepted the notion of the SACU forming the nucleus of the SADC Customs Union and South Africa cannot expect support from Botswana on this matter. Botswana is planning to become an industrial country producing capital goods. If Botswana accepts South Africa's version of the rationalisation process its 'industrial exports' will encounter stiff competition from RSA products in the SACU captive market – a market that is currently dominated by South African capital goods. However if the customs union were to evolve out of the fourteen SADC member states there would be potential new markets for the industrial products envisaged by Botswana.

If SACU were to form the nucleus of the 2010 customs union then current SACU members would qualify automatically whereas new members would have to meet the criteria for SACU membership. The current SADC structure would evolve into the SADC free trade area (FTA) scheduled for 2008, and, thereafter, members would choose the customs union which they would prefer to join. If SACU model is used as the nucleus for the new SADC Customs Union in 2010, there are indications that it would be a success since new members would join on the basis of meeting the current SACU conditions, for example, comparable low tariff lines, the macroeconomic convergence that exists among members (USAID, 2007; Vickers, 2006).

South Africa envisages a new customs union that would not encompass the revenue sharing aspect of the current customs union, but would rather embrace a developmental fund of which the main objective would

be to fund economic development projects. The architecture can take a form of EU Development/Structural Fund.<sup>65</sup> The SADC Customs Union would be based on a new treaty which would negate the Common Revenue Pool (CPR) in its current configuration in the SACU. It may be expected that SADC/SACU member states will initially oppose the idea, but, given time and intense lobbying on the part of South Africa, the idea could succeed. South Africa will have to speed up the review process of the revenue sharing formula (Economic Commission for Africa, 2007; Economic Research Bureau, 2007).

South Africa is of the opinion that the rationalisation of RECs in Southern Africa should take the following dimensions, namely:

- Non-SACU countries, such as Mozambique, should be allowed to join SACU much sooner than 2010, whilst Malawi, Zimbabwe and Zambia may join after 2010. If Mozambique should join there are two likely scenarios: it could join once the reforms have been finalised and accede to these reforms, or, alternatively, it could be part of the reform process. (In fact, SACU reform could also include discussions around new and additional member). In the event of a FTA by 2008, and with Mozambique as a member, other SADC Members would be invited to join on the basis of a new and reformed SACU, a gradual process that hopefully would lead to a fully-fledged SADC Customs Union by 2010.
- The challenge for the new members would be the discrepancy between their tariff levels and the SACU CET. These new members would, under the WTO, be prohibited from introducing new and higher tariff barriers (Viner, 1950) and this is the reason

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<sup>65</sup> The EU Developmental Fund is sourced from the custom and excise duties which are collected and channelled to a common fund. The EU gives back 25 per cent of the monies collected to members for use at their discretion, whilst 75 per cent is administered and distributed by the EU to fund its programmes (Baldwin, 1994).

why they could join only after backloading their tariffs to a SACU tariff level, as per the SADC Protocol on Trade (USAID, 2007). South Africa's position on the SADC integration is not well articulated and this could present a problem for the country in the process. Instead of waiting for the SADC Secretariat to make decisions regarding the integration agenda South Africa should be proactive in suggesting solutions to the challenges of regional integration, especially as regards the rationalisation process.

## **5.8 Conclusion**

The history of regional economic integration in Southern Africa reveals that it has not yet achieved the economic benefits attributable to developing regions, namely, higher levels of welfare exemplified by low poverty levels, and the economic development inherent in infrastructure development and industrialisation. Intra-regional trade is low as a result of lack of complementarities in the exports of the region, as most trade is with countries outside the region.

The region has taken an important step in adopting macroeconomic convergence criteria, which, if achieved, should lead to the inflow of investments into the region by investors taking advantage of the favourable macroeconomic fundamentals that are in place. There is a need for the indicators targeted to be re-examined, for example, the targeting of low inflation will bring immediate benefits to the region as a low inflation level is conducive to direct foreign investment. The rationalisation of the regional economic communities will solve the problem of overlapping membership – a problem which is particularly severe in the Southern Africa region. There are indications that the SACU will be a nucleus of the SADC customs union and this will lead to

its expansion to include those countries that are willing to join through variable geometry.

## CHAPTER 6

### CONCLUSION AND RECOMMENDATIONS

#### 6.1 Conclusion

The focus of the dissertation was to analyse the impact of regional economic integration in Southern Africa on economic development in areas such as infrastructure development, poverty eradication and to ascertain whether it has led to an improvement in the welfare of the people of Southern Africa. Regional economic integration has been found not to have contributed to economic development in areas of deepening industrialisation and infrastructural development. Even in cases where the region has identified common infrastructural projects, such as the spatial development initiative, a shortage of funding has hampered the realisation of such plans. The region has a backlog in infrastructure development, and considerable sums of money are needed to overcome this backlog, sums which member states do not have. The other problems that led to a failure of regional economic integration to achieve the benefits that are attributable to regional economic integration is the overlapping membership by countries in Southern Africa in various regional economic communities with conflicting objectives.

Chapter 2 focused on theories of regional integration. It was found that the theory of regional integration has its roots in Viner's *Custom Union Theory* (1950). Viner's analysis on regional integration, particularly on trade-creating and trade-diverting customs unions as well as on the static and dynamic gains from regional integration, became the theoretical foundation for regional economic integration.

The objectives of regional integration in the developed world differ from those in the developing world in that, in the case of the former, regional integration was pursued once the economies had already undergone development and industrialisation, and the aim of integration was to ensure that these economies continued on the high economic growth path trajectory. In the case of the developing regions regional integration was fostered as a result of external forces that sought to marginalise local/regional economies. Regionalism was a response to those forces which a single individual country was not able to withstand – forces which required a collective response. Relevant factors in this respect are those features of the economies of developing regions such as small markets, lack of infrastructure, and socio-economic problems such as poverty which transcend national borders.

Chapter 3 sought to illustrate the theory of regional economic integration as applicable in developing regions. The advantages pertaining to membership of a regional economic community far outweigh the costs of non-membership. Regional economic communities in developing regions were found to be besieged by overlapping membership and trade dependency, and produced fewer economic benefits accruing to membership as a result of a lack of complementarities in the production structures and the level of economic development. As a result intra-regional trade was found to be minimal in developing regions in comparison to that in developed RECs, such as the EU and NAFTA.

The benefits of regional integration arise from the scale and competitiveness effects of domestic market enlargement, and from the trade creation associated with switching of demand to cheaper suppliers in partner countries. It may also often be the case that, although the net effect of trade creation and trade diversion is negative, there may nevertheless be positive welfare gains for certain individual



partners to a regional trade agreement. For example, the NAFTA agreement has had significant welfare effects for Mexico and Canada. In developing regions (especially sub-Saharan Africa) the benefits accrued as a result of regional economic integration are insubstantial. It is clear that, in order to reap the perceived benefits motivating regional economic integration, it is essential to avoid or minimise the potential costs. It is important for policymakers to be conscious of the economic risks involved and design new regional arrangements accordingly.

Several other dynamic gains may result from RIAs, including the increase in intra- and extra-regional investment as the size of the market increases and internal trade barriers fall. The imports of capital goods and the importation of best practices and new technologies may also lead to an improvement in technology. The dynamic gains could be especially significant if the RIA were designed as an intermediate step towards global integration, rather than as an end in itself.

In Chapter 4 the experiences in regional economic communities were discussed in terms of whether they are compatible with the theory on regional integration as regards the benefits that are accruable. In developing regions the South East Asian and Latin American regions were found to be making gains through regional integration in accordance with Viner's theory on regional economic integration. It was found that the European Union is the ultimate example of deepening regional integration. The EU has evolved from a cooperative arrangement in 1957 to the full economic integration we know today. The danger of developing countries emulating the EU integration process is that, in many cases, conditions are not permissible for the deepening of regional economic integration. Africa was found to have a large numbers of RECs with multiple memberships. The continent has ambitious targets in terms of deepening RIAs which are not feasible. This has resulted in targets not being achieved, which has, in turn, been compounded by Africa's obsession with sovereignty as member states

refuse to surrender the level of sovereignty that is required to deepen integration.

In Chapter 5 the focus was on regional economic integration in Southern Africa. It was revealed that the end objective of integration in Southern Africa was to overcome problems related to the small market of Southern Africa. As per the theories on regional economic integration, it was thought that the integration of the market would lead to economic benefits for member states. Closer analysis, however, revealed that the Southern Africa region is not deriving benefits as a result of the integrated market. This is because of overlapping memberships, in terms of which member states belong to more than one regional economic community, all with the aim of deepening regional integration. With SACU, COMESA and SADC all aiming at further deepening integration, it may be concluded that it will not be possible to realise the timetables set unless member states make a conscious choice on the regional economic community to which they wish to belong. Furthermore, intra-regional trade is minimal compared to other developing regions, such as East Asia, and developed regions, such as the EU.

It is acknowledged (at least by SACU members) that if SACU is used as model of the SADC customs union, it will be successful as SACU is an old institution with respectable credentials. But for such an occurrence is to happen, SACU itself should be reformed from an institution that exists to collect and distribute revenue to an architecture which promotes trade and economic development. As preparations for launching the SADC customs union take shape there is the belief by South African policy makers that SACU should form the nucleus of the SADC customs union.

South Africa is the economic powerhouse of Southern Africa and must lead the region into realising the benefits of regionalism. South Africa must also take the lead in agenda setting. South Africa should continue to lobby other SACU/SADC members to support the idea of the SADC Customs Union which is based on the SACU as a nucleus. Such arrangements should take cognisance of the need to review the SACU revenue sharing mechanism which is not based on the economic activities of the member states. Membership through variable geometry must be well articulated and must be based on realistic criteria that are realisable (even if it is over a period of time) by SADC member states.

## 6.2 Recommendations

In order for Africa and Southern Africa to benefit from regional integration and realise the dream of the Africa Economic Community there must be policy shifts by member states in terms of the following:

- Countries should seek membership in those regional economic communities in which they will attain the best economic benefits. A conscious decision has to be made at the political level to reduce membership to one economic community, for example, in Southern Africa Swaziland must choose whether it wishes to belong to COMESA, SACU or SADC. The same condition applies to all African regions in which countries belong to more than one regional economic community, all of which are aiming at deepening regional integration beyond the FTA. The choice of affiliation should be guided by the economic benefits accruable from such an undertaking, for example, Swaziland and Zimbabwe<sup>66</sup> should choose SADC as opposed to COMESA because their biggest trading partner(s) are to be found in SADC.

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<sup>66</sup> South Africa is the biggest trading partner for both Swaziland and Zimbabwe

- There should be a concerted effort to mobilise resources for regional organisations in terms of finance and human resource skills. Currently, many regional organisations are hampered by the lack of competency in technical matters within their bureaucracy. For example, SADC has several decision-making structures, such as the Sectoral Committees of Ministers, the Integrated Committee of Ministers (ICM), the Council of Ministers and the Summit of Heads of State and Governments. These bureaucratic layers all delay decision making and delay the process of regional economic integration. There is a need to reform SADC to enable it to deal with the real issues of regional integration by allowing those ministers responsible for regional integration to decide on the matters of their competency to bypass other structures and report to the Summit of Heads of States and Government.
- Member states must show commitment to the signed agreements. Sanctions must be imposed upon member states that deviate from the stated principles.
- Governments must involve the private sector in the regional agenda as the private sector could be efficient in producing most goods and services. The principle of subsidiarity should be respected, in terms of which government leads in those projects in which it has a comparative advantage over the private sector. For example, the government should lead in terms of the procurement of public goods, such road and rail infrastructure, building of dams and other projects in which the risk is high and the private sector has little interest. Should the government lack funding for the procurement of public goods, a private-public partnership arrangement could be used as a funding mechanism.

- In Southern Africa no meaningful regional integration will take place until an effort has been made to address the hindrances, such as infrastructure backlog and a lack of complementarities in production structures. The role of South Africa in the region should be that of a leader rather than a follower, especially in those areas in which South Africa is prepared to expend resources for the regional agenda.

Regional economic integration in Southern Africa (in its current state) has achieved little in terms of economic development and the improvement of economic welfare. There are potential economic gains to REC membership provided the structures of the economy in the SADC region is changed in terms of product diversification, building of infrastructure, especially in transport, communication and energy. Going forward, Southern Africa has the potential to attain maximum economic benefits from regional economic integration if the region/member countries adhere to policy choices that lead to an investor friendly environment, confining membership to one REC where the maximum economic benefits can be attained. The idea of using the SACU model as a blue print for the new SADC customs union is very sustainable provided that the institution is reformed to rid it of its revenue sharing formula and replace it with a member-funded development fund, which will respond to the economic developments needs of the region. New members to the SACU-modelled SADC customs union will join through variable geometry.

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