2. Regional Trade Integration

REGIONAL INSTITUTIONAL BACKGROUND

The Southern African Development Community (SADC), representing fourteen member countries, is the major regional partner of USAID's Regional Center for Southern Africa. Table 1 presents the sometimes overlapping regional institutional affiliations of SADC member countries. RCSA also intends to build strategic relationships with a number of the other regional trade organizations to which SADC member countries may also belong, e.g. the Southern African Customs Union (SACU), the Common Market for Eastern and Southern Africa (COMESA), and others. RCSA's core business also involves servicing bilateral USAID missions and U.S. embassies in non-presence countries.

With respect to U.S.-oriented trade promotion activity, most RCSA countries are eligible for benefits under the Africa Growth and Opportunity Act (AGOA) and all are covered by the Southern Africa Global Competitiveness Hub (as well as, in a few instances, by the East and Central Africa Global Competitiveness Hub). In November 2002, the U.S. announced its intention to initiate negotiations on a free trade agreement (FTA) with Botswana, Lesotho, Namibia, South Africa, and Swaziland, which collectively comprise SACU.

In addition, the EU's Everything But Arms initiative covers Lesotho, Malawi, Mozambique, Tanzania, and Zambia. The EU and South Africa negotiated a free trade agreement in 1999. All sub-Saharan African countries are also part of the EU's Cotonou Agreement, until such time as Economic Partnership Agreements are negotiated on a bilateral or regional basis.

IS SMALL SIZE AN ECONOMIC DISADVANTAGE?

One of the primary arguments in favor of regional integration is that small economies cannot compete on their own. The United Nations and other international organizations have studied this issue since at least the 1940's as part of the de-colonization process. The subsequent literature emphasizes the following problems faced by small economies:

- Their small domestic resource base limits the capacity for transformation, resulting in less diversified economic activity.
- There are limited opportunities for economic development and greater dependence on external factors, creating greater economic instability and vulnerability.
- High dependence on a few primary products for exports leaves small economies vulnerable to external shocks and natural hazards.
- Small countries present few(er) opportunities to realize economies of scale.

Concerns boil down to three. First, small economies will have to specialize in what they produce. Second, small economies will be forced to rely on international trade and become vulnerable to foreign shocks. Third, small economies will not be able to take advantage of economies of scale.

Table 1: SADC Country Membership in Regional Initiatives

African Initiatives				*U.S. Initiatives*			
SADC (14)	**SACU (5)**	**COMESA (19)**	**Cross-Border Initiative (14)**	**USAID Bilateral Missions**	**AGOA-eligible Countries**	**SA Global Compet. Hub (14)**	**ECA Global Compet. Hub (18)**
Southern Africa							
Angola		Angola		Angola		Angola	
Botswana	Botswana				Botswana	Botswana	
DR Congo		DR Congo		DR Congo	DR Congo	DR Congo	DR Congo
Lesotho	Lesotho				Lesotho	Lesotho	
Malawi		Malawi	Malawi	Malawi	Malawi	Malawi	
Mauritius		Mauritius	Mauritius		Mauritius	Mauritius	Mauritius
Mozambique				Mozambique	Mozambique	Mozambique	
Namibia	Namibia	Namibia	Namibia	Namibia	Namibia	Namibia	
Seychelles		Seychelles	Seychelles		Seychelles	Seychelles	Seychelles
South Africa	South Africa			South Africa	South Africa	South Africa	
Swaziland	Swaziland	Swaziland	Swaziland		Swaziland	Swaziland	
Tanzania		Tanzania	Tanzania	Tanzania	Tanzania	Tanzania	Tanzania
Zambia		Zambia	Zambia	Zambia	Zambia	Zambia	
Zimbabwe		Zimbabwe	Zimbabwe	Zimbabwe		Zimbabwe	
Eastern Africa							
		Burundi	Burundi	Burundi			Burundi
					CAR		CAR
		Comoros	Comoros				Comoros
					Congo (Bra)		Congo (Bra)
					Djibouti		Djibouti
		Eritrea		Eritrea	Eritrea		Eritrea
		Ethiopia		Ethiopia	Ethiopia		Ethiopia
					Gabon		Gabon
		Kenya	Kenya	Kenya	Kenya		Kenya
		Madagascar	Madagascar	Madagascar	Madagascar		Madagascar
		Rwanda	Rwanda	Rwanda	Rwanda		Rwanda
				Somalia			Somalia
		Sudan		Sudan			Sudan
		Uganda	Uganda	Uganda	Uganda		Uganda

Each of these concerns has some merit, but evidence from around the world suggests that small size is not nearly the problem implied by this list. It is true that small economies are more specialized than larger economies. This tends to be the case in sectors with traded products, but much less so in non-traded goods. To the extent that the required inputs are in the non-traded sector (energy, labor, building materials), this issue is not a serious constraint.

It is also true that specialization in and of itself is not necessarily the problem. Cases exist of small countries specializing in industries which suffer declining global demand and lower prices, such as rubber in Sri Lanka. Other cases demonstrate just the opposite, as in Botswana, where specialization in diamonds has brought substantial economic benefits. Mauritius' recent

specialization in garments has brought it high growth and greater diversity away from its highly volatile sugar exports. Obviously, specialization can be good or bad, depending on the industry. The argument about small economies suffering from diseconomies of scale is not obviously correct either. With trade liberalization, countries can export to the largest market of all: the world market. For instance, it is not clear that Mauritius' small size has prevented it from achieving economies of scale in garment manufacture.

Turning to the global evidence, we find no proof of a bias against small economies. Table 2 shows average GDP per capita of small and large economies, broken out into island and non-island countries. There is little evidence that per-capita GDP is significantly lower in small economies, either among islands or land-based economies.

Table 2: Mean GDP in 1980

(1985 US Dollars per-capita, PPP-adjusted)	**Number of Countries**	**GDP**
Islands	29	4940
Small Islands	17	4918
Non-Islands	113	4715
Small Non-Islands	55	4851

Note: "Small" is defined as having a population of less than 8 million.

MOST IMPORTANT BARRIERS TO GROWTH AND POTENTIAL POLICY ACTIONS BY SADC

The issue of integration of the Southern African region can be thought about along five dimensions. These are:

1. cross-border integration of capital and labor markets;
2. cross-border infrastructure;
3. cross-border integration of institutions and regulatory frameworks;
4. cross-border, inter-firm collaboration through joint ventures and outsourcing arrangements; and
5. cross-border integration of goods and services flows.

In other words, the economically relevant degree of integration depends not only on removal of trade restrictions but any barriers that raise the costs of transport of goods or labor or financial and physical capital.

The literature on regional integration efforts in Africa is fairly skeptical of the economic benefits to be realized from trade integration alone. Radelet (1999) cautions that there is little reason to expect significant economic gains from formal trade agreements in Africa unless they are preceded by decisions within member countries to follow more general open trade strategies. He suggests that the pursuit of more open trade policies, coupled with more disciplined fiscal and monetary policies (and hence more economic stability), and perhaps augmented by regional infrastructure cooperation efforts, appears to be a more promising initial strategy. Jenkins et al. suggest that the SADC Free Trade Agreement (FTA) should not be viewed as an end in itself or as an alternative to more general removal of trade restrictions, but rather as a means of improving

competitiveness in Southern Africa so that the region can take advantage of wider trade and investment opportunities (Jenkins, Leape, Thomas 2000, 21). They also propose that the SADC FTA be viewed as one of a series of trade arrangements in which Southern African countries participate, and suggest that a SADC-EU FTA would be a logical follow-on to the South Africa and SACU FTAs with the EU.

That being said, the barriers to growth within the SADC region are substantial. They include:

- *macroeconomic policy:* lack of internal macroeconomic balance, overvalued currencies, high rates of inflation (Jenkins and Thomas 2000);
- *taxation and fiscal adjustment:* lack of indirect and direct tax policy coordination, persistence of capital controls (Leape 2000);
- *trade policy:* overlapping membership and incoherent rules of origin and trade tariff treatment of SADC member countries in different preferential trade arrangements (Chauvin and Gaulier 2002);
- *foreign direct investment:* [1] political and economic instability, pervasive bureaucracy and inefficiency, lack of regulatory transparency, underdeveloped private sector, restrictions on movements of persons, underdevelopment of capital markets and persistence of capital controls, lack of regional product standards, shortages of skilled labor, low productivity, restrictions on land ownership (Hess 2000);
- *microeconomic considerations:* supply-side constraints relating to provision of physical infrastructure, education and training, and finance; transfer of technology and information; market development activities; political concerns regarding potential job losses from integration, especially in "sensitive industries," so identified in the SADC Protocol on Trade; lack of definition of priorities for launching private sector growth, especially in micro-, small, and medium-sized enterprises; concerns about predatory behavior by local, regional, and international firms; substantial labor market differentials between organized labor in South Africa and workers elsewhere in the region; underdeveloped human resource capacities (Maasdorp 2000).

DRIVING FORCES OF GROWTH TO DATE

Economists' understanding of economic growth has increased dramatically in recent years, helped in part by an equally dramatic increase in the data available for cross-country analysis. Many of these advances have been incorporated in recent years in the data and rankings of the Global Competitiveness Report (GCR). For the 2002-2003 GCR, executives in 80 countries were asked about economic, technology, structural, governance, and other variables to estimate composite indices on microeconomic and growth competitiveness. Countries are ranked by these indices, and shifts in the rankings are tracked from year to year as one indicator of national progress or slippage. Among the 80 countries are five SADC member countries: Botswana, Mauritius, Namibia, South Africa, and Zimbabwe.

The Microeconomic Competitiveness Index is composed of variables regarding company operations and strategy and the national business environment (Porter 2002). "Company operations and strategy" considers production, workforce development, management, marketing,

[1] Many of the barriers identified by Hess with respect to FDI could just as easily apply to the entire group as "barriers to growth."

and R&D factors. The "national business environment" covers variables under the four points of the Porter competitiveness diamond, i.e. factor (input) conditions, demand conditions, related and supporting industries, and firm strategy and rivalry. The Growth Competitiveness Index is based on three broad categories of variables found to influence economic growth, namely technology, public institutions, and the macroeconomic environment (Cornelius et al. 2002).

Data from the 2002 GCR are used to evaluate the growth potential of the five SADC countries. A new LCD Competitiveness Index is developed that ranks the growth potential of LDC countries specifically. The sample is comprised of countries from the GCR data set with incomes below $10,000 in 1991, excluding Eastern Europe, China, and Vietnam.

Macroeconomic variables were first tested for significant correlation with growth. Five variables – the inflation rate, the fiscal surplus as a percent of GDP, the national savings rate, the average spread between bank deposit and credit rates, and exchange rate misalignment – proved to be the most significant in terms of their correlation with growth in the 1990s. Each of these exhibits a significant link to growth during the 1990s and summarizes an important aspect of macroeconomic policy. Inflation is a proxy for monetary policy, the deficit summarizes the sustainability of fiscal policy, the national saving rate represents incentives for capital accumulation, exchange rate misalignment suggests international price competitiveness, and the interest rates spread summarizes the efficiency of financial intermediation.

These five variables were then combined to form a macroeconomics conditions index, according to which developing countries are ranked (Table 3). Malaysia and India top the list. Malaysia is ranked first due to its combination of low inflation, high national savings, low interest rate spread, and relatively competitive exchange rate (a negative number signifies greater competitiveness). India owes its ranking to exchange rate competitiveness plus low interest rate spreads and low inflation.

With this macroeconomics index serving as a control variable, the importance of other key variables in the data set was tested subsequently. These variables measure a wide range of phenomena, from technology, health, and education, to infrastructure, business strategy, extent of clustering, and financial depth. Through this testing, two additional groups of variables were identified that exhibited additional explanatory power over recent growth rates. These variables are summarized in a technology index and an institutions index, also displayed in Table 3. The indices are based on specific variables, but should be interpreted as broad measures of innovation and institutional quality, respectively.

The technology index measures the enabling environment in support of innovative and scientific activities. It is based on the extent to which companies in each country tend to pioneer their own products and the extent to which talented people tend to stay in the country (i.e. a "brain drain" measure). These two indicators are included because they perform best in the statistical tests. Nevertheless they are highly correlated with other aspects of the technical and scientific environment such as the quality of research institutes, the extent of collaboration between universities and businesses, and the quality of technical education.

The institutions index measures four different aspects of institutional strength: corruption, legal systems for settling disputes, organized crime, and legally-supported financial property protection.

Table 3: SADC Country Rankings on LDC Competitiveness Index

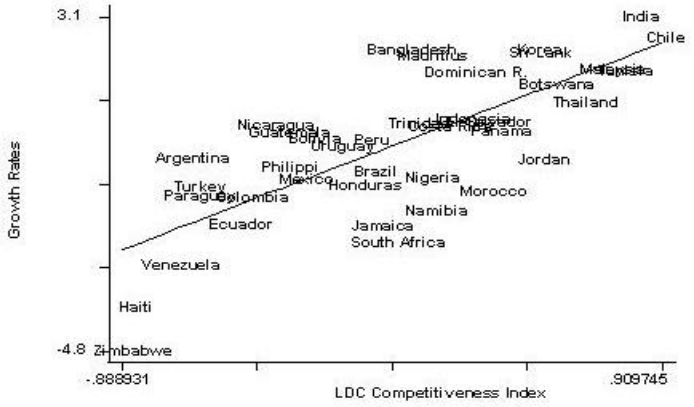
LDC Competitiveness Index		Macroeconomic Index		Technology Index		Institutions Index	
Rank	**COUNTRY**	**Rank**	**COUNTRY**	**Rank**	**COUNTRY**	**Rank**	**COUNTRY**
1	Chile	1	Korea	1	Malaysia	1	Chile
2	Korea	2	Brazil	2	India	2	Uruguay
3	Malaysia	3	Chile	3	Jordan	3	Tunisia
4	Tunisia	4	Costa Rica	4	Panama	**4**	**Botswana**
5	Thailand	5	Malaysia	5	Thailand	5	Korea
6	**Botswana**	6	Thailand	6	Morocco	6	Malaysia
7	Panama	7	Tunisia	7	Tunisia	**7**	**South Africa**
8	Jordan	8	Panama	8	Indonesia	**8**	**Mauritius**
9	**South Africa**	9	Dominican Republic	**9**	**Botswana**	9	Thailand
10	Trinidad and Tobago	**10**	**Botswana**	10	Chile	10	Jordan
11	**Mauritius**	11	Indonesia	11	Korea	**11**	**Namibia**
12	Costa Rica	**12**	**Mauritius**	12	Trinidad and Tobago	12	Sri Lanka
13	India	**13**	**Namibia**	13	Argentina	13	Trinidad and Tobago
14	**Namibia**	14	El Salvador	14	Bangladesh	14	Brazil
15	Morocco	15	India	15	Philippines	15	Costa Rica
16	Sri Lanka	16	Mexico	16	Honduras	16	El Salvador
17	El Salvador	17	Trinidad and Tobago	17	Dominican Republic	17	Peru
18	Dominican Republic	**18**	**South Africa**	**18**	**South Africa**	18	Jamaica
19	Brazil	19	Morocco	19	El Salvador	19	Colombia
20	Uruguay	20	Turkey	20	Sri Lanka	20	Panama
21	Mexico	21	Sri Lanka	**21**	**Mauritius**	21	Morocco
22	Indonesia	22	Colombia	22	Mexico	22	Mexico
23	Jamaica	23	Jordan	**23**	**Namibia**	23	India
24	Peru	24	Guatemala	24	Jamaica	24	Dominican Republic
25	Colombia	25	Peru	25	Nigeria	25	Turkey
26	Argentina	26	Jamaica	26	Venezuela	26	Nicaragua
27	Honduras	27	Uruguay	27	Ecuador	27	Argentina
28	Philippines	28	Honduras	28	Peru	**28**	**Zimbabwe**
29	Turkey	29	Nicaragua	29	Guatemala	29	Bolivia
30	Guatemala	30	Argentina	30	Bolivia	30	Philippines
31	Venezuela	31	Venezuela	31	Colombia	31	Paraguay
32	Paraguay	32	Paraguay	32	Paraguay	32	Venezuela
33	Bolivia	33	Philippines	33	Costa Rica	33	Guatemala
34	Ecuador	34	Bolivia	34	Haiti	34	Ecuador
35	Bangladesh	35	Ecuador	35	Uruguay	35	Honduras
36	Nigeria	36	Bangladesh	36	Turkey	36	Indonesia
37	Nicaragua	37	Nigeria	37	Brazil	37	Nigeria
38	**Zimbabwe**	**38**	**Zimbabwe**	38	Nicaragua	38	Bangladesh
39	Haiti	39	Haiti	**39**	**Zimbabwe**	39	Haiti

The SADC countries are shown in bold type. The SADC countries as a group score relatively better on institutions than they do on macroeconomic conditions and technology. South Africa in

particular is hurt by its relatively low rate of national saving and by the judgment of its business leaders that talented people tend to leave the country, which undermines its technology rating. Botswana and Mauritius obtain high ratings on institutions, but Mauritius is hurt by a relatively high interest rate spread and a relatively large fiscal deficit. Botswana obtains relatively high ratings overall, but its rank is reduced by its relatively poor performance on the extent to which local firms pioneer their own products from the technology index.

The overall ranking of LDC competitiveness is displayed in the left-hand column in Table 3. Chile tops the rankings, followed by Korea, Malaysia, and Tunisia. Chile owes its ranking to strong performances on institutions and technology, while Korea ranks especially high on technology and Malaysia on macroeconomics. The LDC competitiveness index is an average of the macroeconomics, technology, and institutions indices. Figure 1 shows the evidence for a link between this overall index and rates of economic growth during the 1990s. Growth in the 1990s is measured on the vertical axis, while the values for the LDC competitiveness index are on the horizontal axis.

Figure 1: Correlation Between Economic Growth and LDC Competitiveness



The line in Figure 1 depicts the average relationship between growth and the index. For South Africa, Zimbabwe, and Namibia, which lie below the line, growth has been slower than expected, given the variables in the index. Mauritius, on the other hand, has outperformed the index. Botswana is on the line, indicating that the regression relationship exactly accounts for its growth. The relationship depicted in the figure controls for the so-called catch-up effect (i.e. poorer countries grow faster than richer countries, holding other things constant).

These ratings help to focus RCSA's policy considerations by drawing attention to those factors that have exhibited empirical correlation with recent rates of economic growth. For the SADC region, these rankings suggests that the challenge for fast growth is to maintain or improve

macroeconomic conditions while working to improve the supporting environment for innovation, technical change, and diffusion of new technologies within the region. Nevertheless, it would not be correct to take this analysis too far and focus exclusively on these factors, for two reasons. The first is that the future need not be like the recent past, and the second is that there are inevitably country-specific factors that affect growth rates. These country-specific factors must also be understood for an effective policy strategy.

An additional clue about some of the special country-specific factors that can assist growth also comes from Figure 1 above. Note that Mauritius, Bangladesh, Dominican Republic, and Sri Lanka lie above the line. This indicates the presence of some missing country-specific factor that assists growth but that is not captured in the broad competitiveness index. One common denominator among this group is that all have significant textile and garment exports, some of which is assisted through specialized institutions such as export processing zones (EPZs). This may suggest that active export promotion in this sense can provide an additional boost to growth above and beyond the other factors included in the competitiveness index. However, these policies should not be pursued at the expense of improving macroeconomic conditions, institutional strengthening, and technology policy.

The following graphs pursue this point a little further with reference to Mauritius.

Figure 2 plots output, employment, and the stock of capital employed in Mauritian EPZs between 1982 and 2002. After the boom in all three key economic variables in the early 1980s, the number of persons employed in EPZ firms stopped growing significantly around 1987. Capital continued to be invested in the zones up to the early 1990s, after which the capital stock leveled off for a significant period, before picking up again in the very late 1990s. However, EPZ output kept growing throughout the period. This continued growth in output despite the lack of increase in employment and only a moderate increase in capital means that the EPZ sector saw significant productivity gains during the late 1980s and 1990s. In Mauritius, these zones were an engine of productivity and also a significant engine of growth.

Figure 2: Mauritius and Export Processing Zones

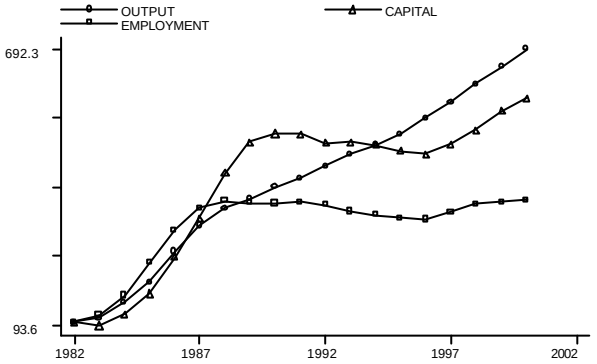
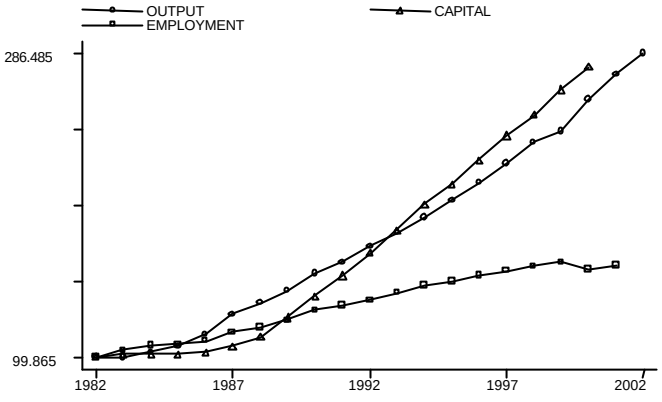


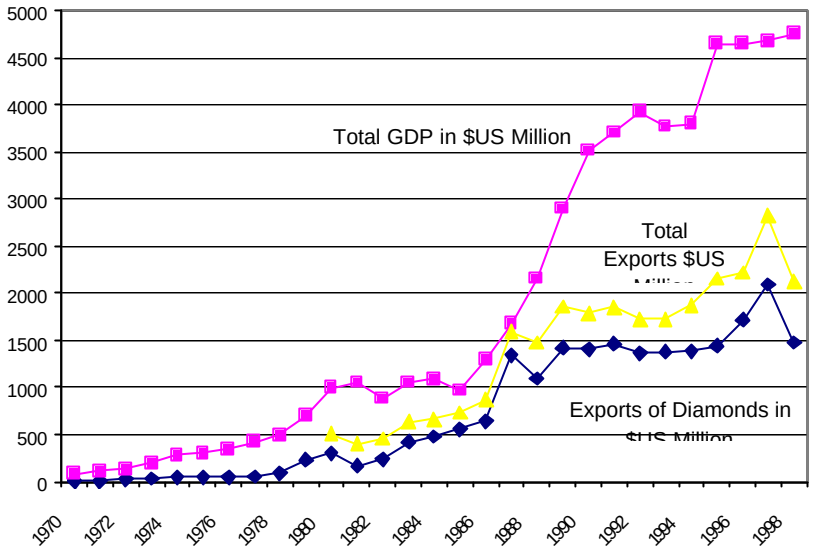
Figure 3: Mauritian Economy Excluding EPZs



Contrast this evidence with what took place in the rest of the Mauritian economy. Figure 3 plots similar data for the rest of the economy, excluding the EPZs. Here one can see that output growth overall was driven by capital accumulation – in other words, there were no clear productivity gains, just a lot of savings accumulation and investment to achieve the growth. This evidence supports the view that Mauritius achieved an extra kick to its growth through export promotion.

The other fast-growing country in the SADC region has been Botswana. Have there been special factors behind Botswana's growth? GDP, exports, and diamond exports are all shown in Figure 4 in U.S. dollars. The figure shows Botswana's rapid growth, but also shows that the increase in diamond exports played an important role in this growth. By the 1990s perhaps a third of Botswana's economy could be directly traced to income from the diamond mines. It is noteworthy that during the 1990s the evidence from the earlier growth analysis suggests that Botswana's rate of growth can be fully explained by the competitiveness index, without appeal to special country-specific factors. This may indicate that Botswana's current rapid growth is sustainable based on its policies and not on continued expansion of diamond exports.

Figure 4: Botswana's GDP, Exports, Diamond Exports



In summary, what have been the driving forces behind growth in the SADC region, and what will be the driving forces in the future? This question can be answered in two ways. First, analysis of the GCR data to understand the driving forces behind LDC growth during the 1990s suggests that this growth has been influenced by macroeconomic conditions and the institutional and technological environments. A significant part of recent growth for the five SADC countries in the GCR data set can be explained in terms of their performance on these indicators. Zimbabwe ranks low in all three areas; the other countries tend to rank lowest in the environment for innovation and macroeconomic conditions. Second, recognizing that only two countries in the region, Botswana and Mauritius, have achieved anything close to the rapid growth of 5 percent or higher that is required to make significant progress in raising living standards raises the question of other, country-specific factors that may have played an important role. In addition to their relatively good performance on the competitiveness indicators, which is part of the reason for the fast growth records of these two countries, export promotion in Mauritius and good fortune regarding diamond mines in Botswana have also played an important role.

LIKELY ECONOMIC EFFECTS OF SADC FTA

Geographic Reallocation of Economic Activity

In addition to the impact of greater trade integration on growth of the region as a whole, greater integration will change the distribution of economic activity within the region. RCSA should know what the likely impacts are, in order to be prepared for them and to craft an intelligent policy towards these changes. We offer two pieces of evidence to understand these likely changes. One is from an examination of the distribution of economic activity across the regions of *large countries,* since by definition these regions are already institutionally integrated. The second is from the experience of the European Union, which has been pursuing greater regional integration for four decades and has a controversial regional aid program to go along with it.

The evidence on growth trends from large countries suggests that over time economic activity migrates away from a) mountainous areas, b) areas far away from coastlines or navigable rivers,

c) tropical areas or areas with extreme climates, and d) towards pre-established cities. The same will probably happen within the Southern African region.

This migration of economic activity comes about both from the movement of mobile factors, such as labor, as well as from greater population growth and different rates of capital accumulation in the remote and favored areas. Greater trade of goods and services may be seen as indirect movement of factors, too, rather than as a separate process.

The only parts of this gravitation of economic activity that may be affected by policy are really the movements of labor and goods. It is very difficult to affect or alter the different rates of accumulation in different regions. Attempting to resist the natural reallocation of economic activity is likely to result in bad policy. There are usually better means to ameliorate any problem than erecting barriers to mobility.

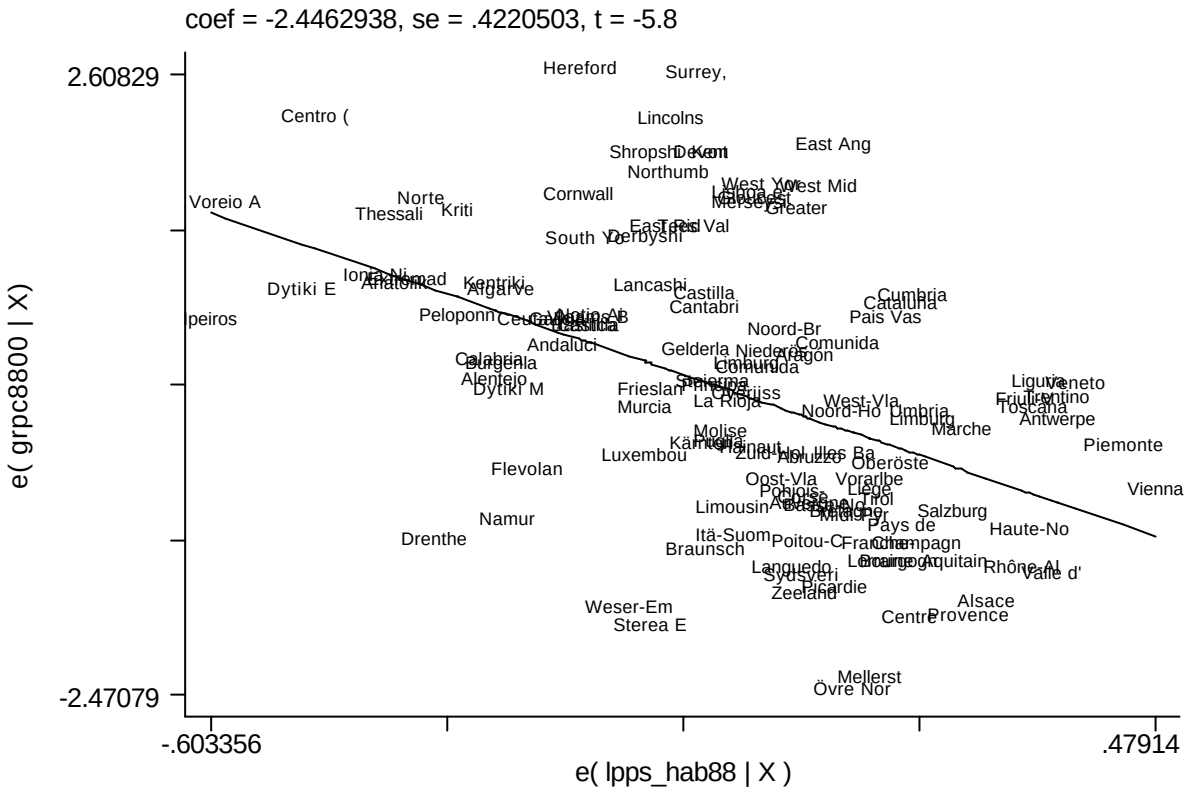
Spatial Convergence of Incomes

Although some argue that this economic activity relocation process will impoverish remote regions that are left behind, this is far from obvious. Although people leave the remote regions, *average* incomes in the remote regions may actually rise as the people that are left behind face less congestion in trying to make a living off of limited economic opportunities. The migration may actually serve to *reduce* regional inequalities.

The evidence from Europe is helpful on this point. In Figure 5 below, growth rates of European regions between 1988 and 2000 are plotted on the vertical axis, and the level of income back in 1988 is plotted on the horizontal axis. Poorer regions are to the left and richer regions on the right-hand side of the graph. Note that the poorer regions actually tend to have had higher growth than the richer regions. That means that regional integration in Europe has served to lessen, not widen, regional income disparities. Although labor, capital, and economic activity have continued to gravitate towards richer regions and cities, and the richer regions have grown, the poorer regions have grown even faster in terms of *average* income.

Europe's regional policy has been first and foremost to reduce barriers to the free movement of goods and services, labor, and capital across the European Union. A secondary aspect of its regional policy has been its programs of regional aid. As Figure 6 below shows, this aid has tended to go to the EU's poorer regions. EU regional development policy is implemented through four Structural Funds and a Cohesion Fund. Seventy percent of the structural funds are allocated to regions whose GDPs are less than 75% of the EU average, while the cohesion fund is spent in member countries whose GDPs are 90% below the EU average, i.e. Greece, Ireland, Spain, and Portugal. The expected cost of EU regional aid in 2000-2006 is €231 billion. On an annual basis, this is about 0.5% of EU GDP. Note in Figure 6 that richer regions (again, to the right of the graph) have tended to receive less regional aid, depicted on the vertical axis.

Figure 5: European Regional Per Capita Income, 1988, and Growth Rates, 1988-2000



The question is whether this regional aid has played a role in the convergence of income levels seen in the earlier graph. The regional aid was partly income support and partly infrastructure projects that would, by facilitating movement of factors, potentially assist the income convergence. Regression analysis performed in the background for this study shows some evidence that the regional assistance did tend to assist income convergence. This is not a firm conclusion, but there is some evidence to support the idea that European regional assistance helped facilitate income convergence among its regions.[2]

Skill Composition of Employment and Effect on Wages

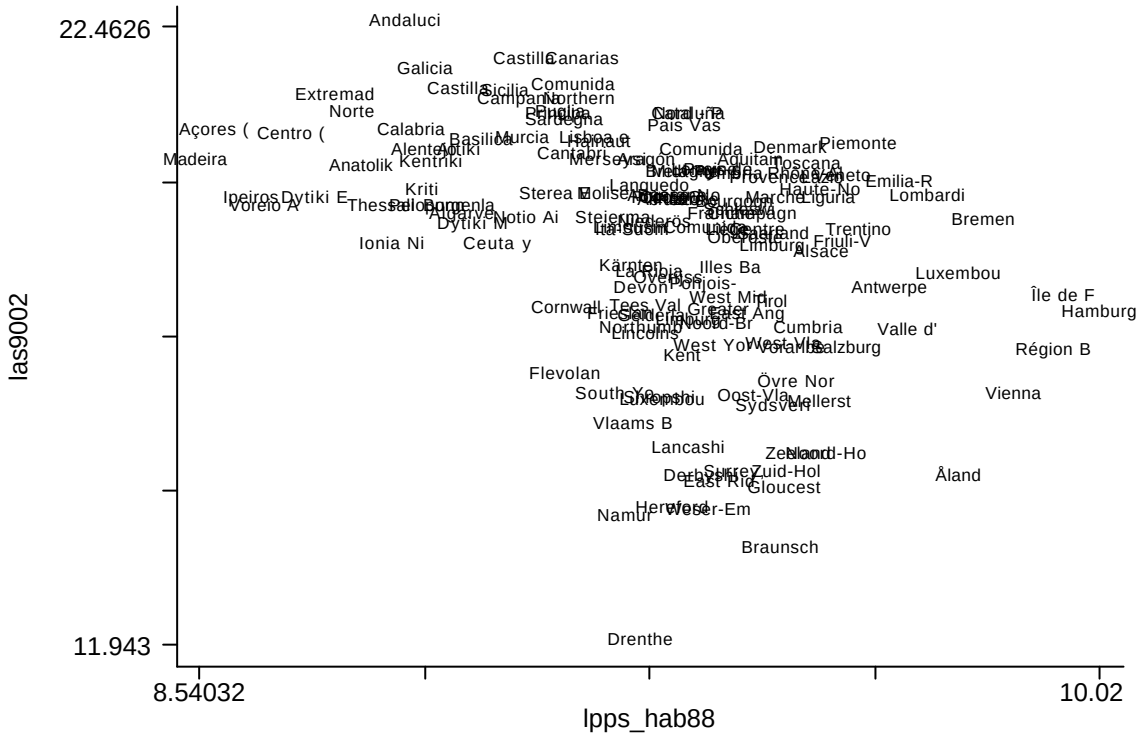
Another important effect of regional (and, by extension, global) trade integration, as economic activity restructures, is the effect on labor markets. As the structure of an economy changes under free trade, the sets of skills required by firms also changes. Increased integration may follow Hecksher-Ohlin principles and favor low-skill, labor-intensive manufacture opportunities, thereby increasing the demand for assembly labor and thus lead to upward pressure on low-skill wages. However, the *relative* increase in demand for high-skilled labor is even greater. Experience with trade liberalization around the world has shown that increased integration with world markets shifts labor demand relatively more in favor of higher- rather than lower-skilled workers, thereby further increasing the spread in wages between qualified and unqualified labor.[3] As the demand

[2] See Jenkins (2000) for a discussion of regional integration schemes' compensatory mechanisms and their possible application to SADC.

[3] Confirmed by experiences in Brazil (Pavcnik et al. 2002), Indonesia (Agrawal 1995), and Mexico (Revenga 1995).

for higher-skilled workers grows, pressure grows for the country's education and training system to provide appropriate curricula, teaching methods, and learning and skills acquisition opportunities.

Figure 6: European Regional Per Capita Income and Regional Development Assistance



South Africa's experience with increased global integration has been a structural change in production toward capital-intensive sectors, an increase in demand for higher skilled labor, and increasing unemployment among low-skilled workers (Tsikata 1999; Lewis 2001; Alleyne and Subramanian 2001). While this is bad news for South Africa's low-skilled workers, with increased regional integration in SADC, it may be good news for other SADC member countries whose low-skilled workers are lower cost than South Africa's.

ANTICIPATED EFFECT OF SOUTH AFRICA ON REST OF SADC

South Africa, representing two-thirds of SADC's exports and three-quarters of its GDP, swamps SADC. The conundrum of South Africa within SADC is of course the presence of a capital-intensive, relatively more industrialized economy, alongside thirteen other countries that are largely primary sector-driven. Free trade within such a region immediately conjures images of the North American Free Trade Agreement with South Africa playing the U.S. relative to the rest of SADC's Mexico. Yet the great irony in SADC is the legacy of apartheid in South Africa, resulting in a labor market story that in some ways mirrors those of the other SADC member countries – with high rates of unemployment and low skill levels – *juxtaposed against* the political and economic importance of organized labor, which has resulted in high wages and stymied employment growth.

So what role will South Africa play in the region? Will South Africa's capital base and more sophisticated value-chains encourage it to make cross-border investments elsewhere in the region,

taking advantage of lower wages for "off-shore" labor-intensive manufacturing, in a NAFTA-ization of Southern Africa?[4] Will various policy constraints to factor mobility, incentives created by the EU-South Africa FTA, and difficulties in efficient transport of goods across borders conspire to keep South African investors reasonably close to home to take advantage of informal labor arrangements in-country and within SACU? Or will the EU-South Africa act as a growth pole for SADC suppliers into South Africa, where inputs can be transformed to satisfy rules of origin for preferential access to the EU market?

Given the difficulties in attracting FDI from abroad, SADC member countries would do well to attract South African investors. They know Africa, they are probably better equipped to handle the risks and uncertainties posed by the region. Examples of South African investments in mining, agro-processing, clothing manufacture, retailing, telecommunications, and banking elsewhere in SADC and around sub-Saharan Africa are growing.

However, in considering this same set of questions using a series of computable general equilibrium model simulations, Lewis, Robinson, and Thierfelder (2002) conclude that because of its limited size, South Africa is *not* a viable growth pole for the region. Access to EU markets and/or world markets provides substantially bigger gains for the other SADC countries than does access to South Africa. They also find substantial gains for the remaining SADC member countries of a SADC-EU FTA, in light of the South Africa-EU FTA.

Model results notwithstanding, there are incentives at work that might yet encourage variations on triangular trade arrangements within the region. The rules of origin of AGOA stipulate that by 2004 all AGOA-eligible suppliers must use U.S.- or African-sourced fiber and fabric in the manufacture of garments for duty-free access to the U.S. market. South Africa's industrial base will certainly seek African cotton – from within SADC, if at all possible – to process textiles that will enter a later stage of the value-chain for processing into apparel – possibly in other SADC member countries, where wage costs are lower. While much of the debate in individual African countries with which one of the authors is familiar has been about creating complete fiber-thread-fabric-clothing value-chains in-country,[5] the RCSA could facilitate the expansion of regional textile-clothing pipelines under AGOA.

[4] Lustig (1998) provides one of the more recent and objective accounts of the impact of NAFTA on the Mexican economy.

[5] Single country considerations have dominated to date in Mali, Uganda, Madagascar, and – albeit to a lesser extent – in South Africa. Source: Salinger and Carpenter (2001); Salinger and Greenwood (2001); Salinger, Bhorat, Flaherty, and Keswell (1998). Madagascar assessment made based on Orsini et al. (2002) and preparation for work to begin in July 2003 (estimated).