SOUTH-SOUTH TRADE
Theory, Evidence, and Policy

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Chris Milner

Recently a number of commentators have argued that trade policy in developing countries should be deployed discriminatorily to encourage the expansion of trade among southern countries. Such a strategy is seen as being central in the framing of a new international economic order. This article evaluates the arguments in favor of a relative expansion of South-South trade and reviews the experience of developing countries with discriminatory regional trading arrangements. It contends that the case for specific policies to promote South-South trade is not convincing and that experience with discriminatory arrangements is not encouraging. The expansion of South-South trade can be expected to continue in the context of multilateral trade expansion, and the potential gains are likely to be greater if this process is allowed to evolve freely in a multilateral setting.

The dominant view of the most appropriate trade strategy for developing countries has shifted in the past decade or so. The received wisdom of the early postwar years, that development efforts were best oriented inward, emphasized import substitution and regarded trade as a source of impoverishment. A minority view in this period was that an inward orientation would retard development and that an outward orientation, in which exports are promoted, would accelerate industrialization (for a historical perspective on these positions, see Little 1982).

In recent years, evidence of the high economic costs of trade substitution has mounted; this evidence, together with the disappointing performance of the most inward-oriented economies and the impressive gains of the outward
oriented, has shifted the weight of opinion, but not decisively (see analyses by Krueger 1981 and by Greenaway and Nam 1988). Some analysts have revived arguments against the multilateral outward orientation. And although the case for outward orientation has gathered force, it has taken the direction of discriminatory export promotion, calling for something of a hybrid of the two older positions in which intervention would reduce North-South trade in favor of South-South trade. We believe, and this paper argues, that developing countries have more to gain from a multilateral (North-North, North-South, South-South) expansion of trade than from efforts directed at any narrower liberalization.

A note on our terminology is in order at the outset. Although policymakers in developing countries may view the North and the South as two clearly discernible groups of countries, the economic and structural characteristics of these countries are not so easily classified. Nevertheless, we use the term “North” as shorthand for the industrial market economies and “South” as shorthand for developing countries because they are widely used as such in the debate over policy.

To evaluate the case for intervention, we first set out the arguments commonly propounded in support of the expansion of South-South trade. We then examine the current importance of South-South trade, the possible extent of South-South trade expansion that could occur without intervention, and the effect of South-South integration efforts thus far. Last, we assess the policy options available to southern policymakers wishing to expedite expansion of South-South trade and summarize the case for the multilateral expansion of trade.

The Political Economy of South-South Trade

The calls for a discriminatory policy favoring South-South trade are based on a variety of arguments, some of which overlap with those in support of an inward orientation, including the growth of self-reliance and the protection of infant industries (Amsden 1987). Some analysts explain the South’s dependence on capital and high-technology goods from the North as part of a vicious cycle that cannot be broken without some governmental intervention. For instance, northern manufacturers can mass-produce sophisticated goods at lower costs because a huge global market for them exists simply because southern producers are not producing the goods themselves. Southern manufacturers cannot enter the market because of the high costs (and thus high prices) at initial low levels of production, relative to the prices that the northern producers can ask. By the same token, they do not benefit from learning by doing; manufacturers of any one high-technology product will more readily be able to adapt production to changing demands and to expand into production of other high-technology goods, thus keeping start-up costs and prices lower than those of...
potential southern producers. Proponents of this view suggest the use of tariff preferences to promote entry of southern producers in southern markets at the expense of northern producers. Whether externalities are important in these kinds of markets is an empirical question.

Structuralist analyses also emphasize asymmetries in the distribution of gains from North-South trade, alleging that the rich North captures the bulk of the gains from trade partly because of greater bargaining power and partly because producers of primary goods suffer worsening terms of trade with the North. These structuralist arguments, which claim that the distribution of the gains from South-South trade would be much more equitable, were influential in the calls for a new international economic order designed to give the South a better position in international trade and finance (see Palma 1987).

Arthur Lewis adds another dimension to the case for South-South trade expansion. In his lecture on being awarded the Nobel Prize in economics (Lewis 1980), he resuscitates the hypothesis of trade as an engine of growth and points to a stable long-run relationship between growth in the industrial market countries and growth in the developing countries. Because growth in the former has slowed and shows few signs of regaining the trend levels of 1948–73, it follows that growth in the latter will suffer unless South-South trade expands to fill the gap. And Lewis argues that policy intervention is necessary for South-South trade to expand (see Riedel 1988 for a critique).

The growth of the new protectionism in the North (see Greenaway 1983) has provided another way to make a case for South-South trade. Empirical research shows that the North is increasingly using nontariff barriers, possibly in part to discriminate against the South (Nogués and others 1986). Why therefore expand exports to northern markets if the inevitable response in those markets is the erection of protective barriers? These barriers are likely to rise if only because the capacity of northern markets to increase their absorption of southern goods is limited. By contrast, potentially greater capacity to absorb goods exists in the South, and South-South liberalization could create the environment appropriate to the exploitation of that capacity. The arguments for expanded South-South trade that rest on northern protectionism are labeled by Bhagwati (1988) the “second export pessimism.”

Analysts have clearly articulated all of the foregoing arguments. Among policymakers in the South, two other arguments, less precisely specified and more in the nature of beliefs, have probably been more influential than the analyses in the literature. The first, what might be termed comparative-advantage pessimism, is that many developing countries do not have an advantage in anything compared with the industrial world, a belief widely held in the South. Since comparative advantage is a relative concept, however, the argument is fallacious. The second argument is that South-South trade will promote southern self-reliance.

These analyses and beliefs, which have been voiced by a growing coalition assembling on the South-South platform in recent years, raise several questions
from an economist's standpoint. One is whether the determinants and economic effects of South-South trade systematically differ from those of North-South trade. Another is whether the growth of South-South trade requires deliberate intervention—that is, why should it not grow of its own accord? Finally, developing countries have already made a large number of integration arrangements to stimulate South-South trade; if it is the case that these arrangements have failed, why should the developing countries consider more of them?

**How Important Is South-South Trade?**

Exports by developing countries to other developing countries constitute the smallest component of world merchandise trade (table 1). North-North trade is the largest component; the value of South-South trade is half that of South-North trade and thus about one third of the value of all merchandise exports from the South. The oil-exporting countries and the small number of newly industrializing economies (NIEs) are a minority of developing countries; most developing countries depend on commodities for their export earnings, and the proportion of South-South trade in the exports of such countries tends to be smaller than average. For example, the share of South-South trade in the total merchandise exports of low-income and middle-income countries ranged from 25 percent to 32 percent in 1985 (table 2). In the case of Sub-Saharan Africa the proportion was only 17 percent.

The share of South-South trade in the merchandise exports of developing countries has been growing over the past two decades, rising from 25 percent of such exports in 1965 to 30 percent in 1985 (table 2); and from 1973 to 1982,

<table>
<thead>
<tr>
<th>Table 1. North-South Merchandise Trade, 1986</th>
<th>Importer</th>
<th>Industrial countries</th>
<th>Developing countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exporter</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Industrial countries</td>
<td>1,083.8</td>
<td>319.3</td>
<td></td>
</tr>
<tr>
<td>Developing countries</td>
<td>294.5</td>
<td>143.7</td>
<td></td>
</tr>
<tr>
<td>Oil-exporting countries</td>
<td>74.3</td>
<td>30.9</td>
<td></td>
</tr>
<tr>
<td>Six NIEs a</td>
<td>99.8</td>
<td>59.2</td>
<td></td>
</tr>
<tr>
<td>Other b</td>
<td>120.4</td>
<td>53.6</td>
<td></td>
</tr>
</tbody>
</table>

a. Newly industrializing economies: Brazil, China, Hong Kong, Republic of Korea, Mexico, and Singapore.
b. Includes Hungary, Poland, and Romania.
Source: International Monetary Fund 1987.
merchandise exports from non-oil-exporting developing countries grew more rapidly than South-North trade.

Trade policy on manufactures has received the greatest attention in the many developing countries bent on industrialization, and South-South trade in manufactures between 1973 and 1982 grew 20 percent a year on average—faster than South-North, North-South, or North-North trade. The rates of growth for South-South trade in manufactures must, however, be viewed with some caution. First, the market for manufactured exports in the South is currently small, and such rates of growth may not be sustainable. Second, a few rapidly industrializing economies, in particular Brazil, Hong Kong, the Republic of Korea, Singapore, and Taiwan, have accounted for much of the export growth. In fact, the proportion of manufactured exports from low-income and middle-income countries shipped to other developing countries was smaller in 1985 than in 1965 (table 2). Finally, the NIEs and the oil-exporting developing countries have been the destination for much of the additional southern exports.\(^1\) Newson and Wall (1987) show that much of the growth in South-South trade is accounted for by inter-NIE trade. Havrylyshyn and Wolf (1983) show a significant expansion of exports from NIEs to the capital-surplus oil-exporting countries.

Over recent decades, developing countries have fairly consistently substituted manufactures for primary products in their exports to the North as well as to the South. The share of manufactures rose from 5 percent of South-South trade in 1962 to 27 percent in 1985 and from 20 percent of exports to all destinations in 1965 to 41 percent in 1985 (table 3). This increase has even accelerated in the recent past because of the decline in the price of oil and the resulting fall in the value of oil exports. Thus South-North and South-South specialization need not be viewed as mutually exclusive processes. Indeed, the

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**Table 2. Proportion of Exports from Developing Countries Shipped to Other Developing Countries, 1965 and 1985**

(percentage of value)

<table>
<thead>
<tr>
<th>Developing country group</th>
<th>Merchandise 1965</th>
<th>Merchandise 1985</th>
<th>Manufactures 1965</th>
<th>Manufactures 1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>All</td>
<td>25</td>
<td>30</td>
<td>32</td>
<td>32</td>
</tr>
<tr>
<td>Oil exporters</td>
<td>25</td>
<td>22</td>
<td>34</td>
<td>16</td>
</tr>
<tr>
<td>High-income oil exporters</td>
<td>27</td>
<td>40</td>
<td>49</td>
<td>36</td>
</tr>
<tr>
<td>Exporters of manufactures</td>
<td>28</td>
<td>35</td>
<td>34</td>
<td>36</td>
</tr>
<tr>
<td>Low-income(^a)</td>
<td>29</td>
<td>32</td>
<td>37</td>
<td>27</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>19</td>
<td>37</td>
<td>44</td>
<td>40</td>
</tr>
<tr>
<td>Middle-income</td>
<td>20</td>
<td>25</td>
<td>46</td>
<td>37</td>
</tr>
<tr>
<td>Upper middle-income</td>
<td>26</td>
<td>30</td>
<td>31</td>
<td>31</td>
</tr>
</tbody>
</table>

a. Excludes India and China.

Table 3. Composition of Exports from Developing Countries by Destination, for Selected Years, 1962–85
(percentage of value)

<table>
<thead>
<tr>
<th>Product group</th>
<th>To all destinations</th>
<th>To the South</th>
<th>1965</th>
<th>1985</th>
<th>1962</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fuels, minerals, and metals</td>
<td>32</td>
<td>78</td>
<td>39</td>
<td>54</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other primary products</td>
<td>48</td>
<td>17</td>
<td>21</td>
<td>18</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Manufactures</td>
<td>20</td>
<td>5</td>
<td>41</td>
<td>27</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


growth in importance of trade in manufactured goods applies also to North-North trade. But therein lies a danger: that a desire to expand South-South trade leads analysts and policymakers erroneously to apply the modern explanations for the growth of North-North trade to the case of developing countries.

The Natural Sources of South-South Trade

Trade theory identifies a range of factors that might induce comparative advantage in the production of particular products among countries. Traditional theories of the basis for trade emphasize the role of dissimilarity of economic structures among countries; more recent models emphasize similarity.

Dissimilarity and Interindustry Specialization

The theory of comparative advantage in both the classical and the neoclassical literature identifies differences in relative production costs as the stimulus for specialization in certain products. The general theory suggests that if one country can produce a particular good (food, for example) more cheaply than other products, that country should specialize in production and export of food. Clothing could be the lowest-cost good produced by another country, for example, and the theory would then suggest that the second country should produce and export only clothing in exchange for imports of food. Variations on this theory concentrate on specific sources of dissimilarity in production costs. Ricardian theory suggests that differences in technology or labor productivities are the basis for trade. In contrast, the Heckscher-Ohlin-Samuelson (HOS) model of trade focuses on variations among countries in relative factor endowments (land, labor, and capital) and in the factor usage of particular products.

Given the HOS framework, to analyze the potential for trade between countries in the North and South one must assess the differences in factor endow-
ments between trading partners. These would then be compared with the factor intensities of particular goods to determine which would be expected to be the focus of production and export of each group. HOS predicts that countries will specialize in and export commodities that use their relatively abundant factor intensively.

Empirical evidence on actual trade patterns confirms that such flows do reflect differences in the characteristics of trading partners as suggested by the theory of comparative advantage. Studies by Hufbauer (1970) and Leamer (1974) conclude that endowments of resources, stage of development, technological sophistication, and a range of other national attributes are significantly correlated with the composition of a country’s exports. The influence of factor endowments on trade patterns (the HOS model) also is supported by empirical studies, especially when natural resources and labor skills and training are taken into account (see Deardorff 1984, Leamer 1984, Stern 1975, and Tharakan 1985). Similarly, studies that focus specifically on North-South trade find that factor endowments of trading partners and factor intensity of traded products are consistent with the HOS model.²

The evidence on the similarity of the northern countries’ factor endowments and their dissimilarity with those of the southern countries supports the HOS theory on South-North trade, but intracountry exchange in North-North trade suggests that the southern countries are not a similar or homogeneous group. The differences in resources and per capita income between low-income countries on the one hand and NIES and high-income oil exporters on the other are greater than they are among the industrial countries. This evidence seems to be consistent with the notion of a ladder of comparative advantage as defined by relative factor endowments. Those countries higher up the ladder appear to export relatively more capital-intensive goods and import relatively fewer capital-intensive goods.³ This suggests that there is likely to be continued scope for trade based on differences in factor endowments between developing countries at opposite ends of this ladder.

The present level of trade between developing countries also cannot be expected to reflect the full scope for South-South trade. The level and pattern of South-South trade has no doubt been influenced by the trade policies of the developing countries themselves. Import substitution pursued with the aid of tariff and nontariff barriers has been and continues to be widely employed in the South. Such strategies restrict market opportunities for South-South trade and create an antiexport bias that discourages the production of nontraditional exports. As a result, policies of import substitution have tended to increase the dependence of the South on imports of intermediate and capital goods from the North and have thereby restricted South-South trade.

What emerges from the empirical testing of orthodox trade theory is that dissimilarity of supply conditions simultaneously generates South-North and South-South trade. Indeed, in this context, the labels North and South may be inappropriate because no special or distinctive theories need be applied to
groups of countries. This conclusion might lead to pessimism about the prospects for developing countries: if trade is induced by dissimilarity of supply conditions, then it requires that differences in per capita income, factor endowment, and technology be sustained; such trade may be expected to wither with development, increased factor mobility, and the resulting increase in similarity. But the increasing similarity of supply and demand conditions within the North has not been accompanied by a withering of trade. North-North trade within industries has actually grown over the postwar period in absolute and relative terms. Thus pessimism about North-South and South-South trade would not be warranted: increased similarity between countries reduces the relative importance of HOS-based trade and induces intraindustry trade. This process may be expected to occur in poorer countries as they develop.

**Similarity and Intraindustry Specialization**

Research by Verdoorn (1960) and Balassa (1966) on trade within the European Community (EC) found that specialization within industries was growing and that trade flows in similar manufactured goods between similar, high-income, industrial economies were expanding. This kind of evidence was apparently at odds with the standard HOS model, and it inspired a search for alternative explanations of trade. In the similarity thesis, first propounded by Linder (1961), the narrowing of income differences between any pair of countries would expand rather than diminish trade because a growing portion of the demand in each country would overlap, thereby widening the potential for bilateral trade in differentiated goods. The overlap of international tastes would extend markets for home-produced varieties, and economies of scale would encourage specialization in specific varieties.

The Linder thesis did not constitute a universal model of intraindustry trade, but in recent years a large number of models in this tradition have emerged, allowing for increasing costs of production, product differentiation, and non-competitive markets (for a survey, see Greenaway and Milner 1986 and 1987b). Although most empirical studies cover trade flows of industrial market economies, some focus on intraindustry North-South trade (for example, Balassa 1986 and Tharakan 1984 and 1986) and on the trade of developing countries (for example, Balassa 1979 and Havrylyshyn and Civan 1985). In these studies the share of intraindustry trade in total trade is positively related to a country’s per capita income, its size, and the degree to which demand is similar to that of its trading partners. The consensus, therefore, is that much North-South and South-North trade is explicable in terms of differences in factor endowment and that intraindustry trade is predominantly a North-North phenomenon. The converse, that North-North trade is primarily intraindustry, is also true; in 1978, for example, the share of intraindustry trade in total trade was 64 percent (Greenaway and Milner 1986). The small size of domestic markets in many developing countries and their dissimilarity with the larger markets of
the North are conducive to the specialization of separate industries; North-South exchanges result. Low per capita incomes have therefore restricted the scope for South-South intraindustry trade.

The importance of intraindustry trade has grown for NIEs. Havrylyshyn (1983) shows that the average share of intraindustry trade in total trade was 42 percent for NIEs in 1978, not far from the average of 59 percent for the industrial North and nearly triple the 15 percent for the rest of the developing countries. But he also shows that most of this trade was with the North and that most of the rest was with other developing countries not classified as NIEs. That relatively little of it was with other NIEs may be explained by the geographical spread of the NIEs and by policy interventions. In the case of some of the Southeast Asian NIEs, for example, the incentive structure orients production toward the industrial markets. Protection in the industrial countries may also encourage vertical specialization by multinational firms, which fosters two-way trade in parts and components in exchange for final products.

This pattern of trade is consistent with the view that intraindustry specialization in North-South and South-South trade can be simultaneous and natural processes. The NIEs climbed the ladder of development as they built up their physical and human capital, and their structure of trade has changed in the process. Largely exporters of resource-intensive products before the 1960s, they first increased their competitiveness in labor-intensive goods, textiles, and clothing and then in other consumer goods. In the past decade they have moved into more capital-intensive and skill-intensive engineering and industrial goods, acquiring in the process greater intraindustry specialization.

Other developing countries appear to be broadly following the same pattern of evolution. In the decade after 1973 the share of non-NIE developing countries in exports of labor-intensive consumer goods from the South increased, which tended to increase North-South and interindustry trade in relative terms. Intraindustry trade in manufactures in both total trade and South-South trade is now of some significance in absolute terms, and the market constraints on its growth can be expected to decline as per capita incomes and industrial diversification increase in the South.

Thus there are persuasive reasons for believing that intraindustry trade will become increasingly important to developing countries. All of the evidence we have suggests that the importance of the phenomenon grows with rising per capita income and the spread of manufacturing. Several commentators have already observed similarities between the process of diversification in the NIEs and that currently under way in the "new exporting countries" (see Havrylyshyn and Alikhani 1982). As we have emphasized, intraindustry trade is related to the exploitation of economies of scale. As more developing countries climb the ladder of industrialization and gain access to larger global markets, their growing intraindustry specialization will provide a stimulus to more intraindustry trade, both North-South and South-South.

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Although this scenario appears to be the natural long-term prospect, it does not rule out the possibility that discriminatory trade policies might hasten its development. To consider the potential for intervention, we review the experience thus far with arrangements for South-South integration.

The Extent and Results of Arrangements for South-South Integration

One obvious indicator of the willingness, indeed anxiousness, of developing countries to stimulate South-South trade is the proliferation of South-South integration arrangements in the postwar period. Of twenty current integration arrangements worldwide, fifteen are South-South agreements. The preponderance are in Africa and Latin America, with only one in Asia (table 4). Current integration arrangements directly affect about seventy developing countries.

Although the detailed motivations may vary from case to case, the popularity of integration pacts in the South can be explained in general by a combination of political and economic considerations. Politically, the governments signing the agreements see integration as improving their stability and that of their region.

From the economic standpoint, the countries signing the pacts believe, first, that they strengthen the bargaining power of small open economies in international markets, an important consideration because negotiators from the South are preoccupied with an alleged asymmetry in the distribution of the gains from North-South trade. Indeed, developing countries initiated many integration arrangements during the export pessimism of the 1960s as a part of an overall inward-looking trade strategy.

Second, South-South trade and North-South trade are frequently assumed to be substitutes rather than complements; any stimulus that integration provides to South-South trade would therefore displace an equivalent amount of trade with the North and lessen the South's dependence on the North.

Third, the promoters of integration generally assume that it will generate productive reallocation of resources. In effect, this amounts to the belief that relatively low-cost imports will displace relatively high-cost producers in the home market (this is called trade creation) and that the gains from this will exceed the losses generated when relatively high-cost imports gain sufficient preferential access to the local market to replace what are otherwise relatively low-cost imports (trade diversion).

Fourth, advocates of integration claim it creates dynamic gains: economies of scale rise as market access widens, and efficiency increases as domestic producers respond to greater competition.

Last, a relatively new justification, articulated most notably by reference to the Latin American Integration Association (LAIA), is that South-South integration can help alleviate the debt crisis. Given limited scope for the expansion of
Table 4. Trade Integration Arrangements among Developing Countries, 1989

<table>
<thead>
<tr>
<th>Region and organization</th>
<th>Participating countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Africa</td>
<td></td>
</tr>
<tr>
<td>Communauté Economique de l’Afrique de l’Ouest (CEAO)</td>
<td>Benin, Burkina Faso, Côte d’Ivoire, Mali, Mauritania, Niger, Senegal</td>
</tr>
<tr>
<td>Mano River Union (MRU)</td>
<td>Guinea, Liberia, Sierra Leone</td>
</tr>
<tr>
<td>Economic Community of West African States (ECOWAS)</td>
<td>CEAO members, MRU members, Cameroon, Gabon, Gambia, Ghana, Guinea-Bissau, Nigeria, Togo</td>
</tr>
<tr>
<td>Union Douanière et Economique de l’Afrique Centrale (UDEAC)</td>
<td>Cameroon, Central African Republic, Congo, Gabon</td>
</tr>
<tr>
<td>Communauté Economique Pays des Grand Lacs (CEPGL)</td>
<td>Burundi, Rwanda, Zaire</td>
</tr>
<tr>
<td>Communauté Economique des Etats de l’Afrique Centrale (CEEAC)</td>
<td>UDEAC members, CEPGL members, Chad, Equitorial Guinea, Sao Tome and Principe</td>
</tr>
<tr>
<td>Southern African Customs Unit (SACU)</td>
<td>Botswana, Lesotho, Swaziland</td>
</tr>
<tr>
<td>Southern African Development Coordination Conference (SADCC)</td>
<td>Angola, Botswana, Lesotho, Malawi, Mozambique, Swaziland, Tanzania, Zaire, Zimbabwe</td>
</tr>
<tr>
<td>Asia</td>
<td></td>
</tr>
<tr>
<td>Association of South East Asian Nations (ASEAN)</td>
<td>Brunei, Indonesia, Malaysia, Philippines, Singapore, Thailand</td>
</tr>
<tr>
<td>Latin America and the Caribbean</td>
<td></td>
</tr>
<tr>
<td>Caribbean Community (CARICOM)</td>
<td>Antigua and Barbuda, Barbados, Belize, Dominica, Grenada, Guyana, Jamaica, Montserrat, St. Kitts and Nevis (including Anguilla), St. Lucia, St. Vincent and the Grenadines, Trinidad and Tobago</td>
</tr>
<tr>
<td>Eastern Caribbean Common Market (ECCM)</td>
<td>Special regime within CARICOM for its less developed members</td>
</tr>
<tr>
<td>Latin American Integration Association, successor to Latin American Free Trade Association (LAFTA)</td>
<td>Mexico plus all South American countries except French Guiana, Guyana, and Surinam</td>
</tr>
<tr>
<td>Central American Common Market (CACM)</td>
<td>Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua</td>
</tr>
<tr>
<td>Andean Group</td>
<td>Bolivia, Chile, Colombia, Ecuador, Peru, Venezuela</td>
</tr>
</tbody>
</table>

exports to an increasingly protectionist North, stimulus of South-South trade could facilitate dedollarization of trade payments, greater coordination of policy, and ultimately more stable growth.

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Have South-South integration arrangements been a success? Evaluating the results of economic unions is no easy matter, as analysts of the most extensively researched economic union, the EC, have discovered, even apart from the fact that one never knows what would have happened in the absence of the union. One obvious way of inferring something about a union’s success is whether its membership expands, remains constant, or declines over time. Against this measure, some unions, like the East African Community and the Andean Group, have failed; and others, like LAIA, which is, in effect, an enlarged Latin American Free Trade Association (LAFTA), have succeeded. Most analysts, however, focus on the trade effects of South-South arrangements, and in these terms South-South agreements have generally failed to encourage South-South trade. For instance, in LAFTA, the largest regional grouping in Latin America until its dissolution in 1980, intraregional trade expanded from about 8 percent of the members’ total trade in the early 1960s to about 11 percent in the early 1970s. In the Andean Group, which was evidently initiated as a response to the limited progress of LAFTA, intraregional exports increased from about 2 percent of the members’ total trade in 1970 to about 4 percent in 1984. Ahmad (1972) reports similarly sluggish growth in the case of the Central American Common Market (CACM). Although the trade performance of individual members of the Association of South East Asian Nations (ASEAN) has been impressive in recent years, the growth of intraregional trade has also been slow. The sketchy evidence on African arrangements indicates that the growth of intra-African trade has been modest. The one exception in Africa appears to have been the early years of the now defunct East African Community, whose formation built on well-established trading links. The leading commentator on the East African Community argued, however, that “it is in fact possible to interpret the establishment of the Community, not as a stride forward in co-operation, but as a stage in the process of disintegration” (Hazlewood 1979).

The systematic analysis of integration, as opposed to the more descriptive evidence, is rather limited. One of the most thoroughly investigated unions is CACM. Although the evidence is not unambiguous in this case, the consensus (Willmore 1976 and Cline 1978) is that trade diversion has been slightly more important than trade creation. This result is consistent with studies of the EC, in which the combined effects of trade diversion and trade creation, although positive, were also found to be small. In the case of the EC, however, bigger gains are seen from effects other than trade creation: economies of scale, reduced inefficiencies, and induced flows of capital, labor, and technology (see Owen 1983). But according to several studies, South-South integration has not yielded economies of scale (see Carnoy 1970 on Latin America, Pearson and Ingram 1980 on Ghana and Côte d’Ivoire, and Willmore 1978 on the CACM). Willmore (1978), for example, finds the CACM pact supporting oligopolistic behavior such as market sharing rather than specialization and economies of scale.
The reasons for the poor record of South-South arrangements in stimulating trade expansion are not hard to find. One significant problem has been that the members of some of the unions not only have small markets and low incomes but are at comparable stages of development (that is, they have comparable production structures). A union among similar economies presumes that trade expansion will come from intraindustry specialization and product differentiation. Such expansion has been found among the members of the EC, where market size and incomes can support such specialization, but it is far less possible among comparable but smaller, poorer markets (see Balasubramanyam 1989 for the case of ASEAN). In any event, the South has resisted any inter- or intraindustry specialization that may be induced by intraregional competition.

A second problem arises from the content of the various agreements. Details vary, but the key instrument of integration in the pacts is usually the preferential trading arrangement (PTA). The tariff concessions negotiated under the PTA in turn are commonly negotiated item by item rather than across the board. Negotiating in this fashion is cumbersome and costly and encourages members to be selective in the offers they make, so that exclusions are numerous, whereas preferences are idiosyncratic at best. As Balasubramanyam (1989) remarks in the context of the ASEAN, “The member countries appear to have exercised their right to exclude items fairly liberally.... [Conversely,] Thailand offers tariff cuts on wood products which it does not import and the other members do not produce, Indonesia offers a 10% tariff cut on snow ploughs, and Malaysia includes on the list of preferences a number of rubber products of which it is a major exporter” (p. 173).

Moreover, PTAs typically cover tariffs only and exclude the full range of nontariff barriers, such as legal and administrative requirements and health and safety standards. The effects of a particular tariff cut can be subverted by a specific nontariff intervention, which can also be deployed competitively in bids to attract foreign direct investment. For example, all of the members of LAIA have provisions about the use of local contents in the manufacture of automobiles, and they are all different; and countries of the Caribbean Community compete despite common rules on local content for a range of industries.

The use of nontariff barriers among South-South trading partners is symptomatic of the contradiction of adopting a multilateral agreement to liberalize trade while pursuing an inward-oriented development strategy. Ironically, customs unions among developing countries have been promoted on the grounds that they protect infant industries by shielding the higher-cost regional products from competition from outside the region. But experience shows that even these restricted opportunities for regional specialization and economies of scale have been resisted by union members, even in the case of outward-oriented economies such as those of ASEAN. Wionczek (1970) points to inward-oriented policies as a principal constraint in the case of LAFTA, and Hazlewood (1979) does so in the case of the East African Community.
Another crippling feature of these unions is their lack of redistributive mechanisms. Invariably some members of an agreement gain more than others, especially when they are at different stages of development. Asymmetrical gains without a formal mechanism for redistribution can create political tensions among the members that undermine their commitment and can eventually destroy the union. Hazlewood (1979) sees these forces in the East African Community, Vargas-Hidalgo (1979) in the Andean Group, and Wionczek (1970) in LAFTA.

The history of South-South integration arrangements thus far is not encouraging for future prospects for intraregional South-South trade. But is that an inevitable consequence of the prevailing economic characteristics of developing countries and of the various regions of the South? Or are there greater potential gains to be reaped from more appropriate forms of integration and from more suitable policies? Similarly, can South-South trade be encouraged by discriminatory policies other than regional integration? It might be argued that such questions can be ignored if nondiscriminatory trade liberalization is preferable to discriminatory trade liberalization. But in a less than perfect world we need to give attention to the ranking of policy interventions.

Policy Intervention and South-South Trade

As we have seen, South-South trade as a proportion of total southern trade has grown—slowly over the past two decades, and more rapidly in recent years with the emergence of South-South intraindustry trade. In our review of the engines of this expansion, we identified forces likely to stimulate further growth in the medium to long run: on the supply side, technology transfers, and on the demand side, rising incomes. The latter will increase demand for manufactures, and the former will allow the expansion of southern capacity to meet this demand. Thus with shifting comparative advantage comes a reasonable expectation of expanding South-South trade.

If southern policymakers attempted to speed this rate of change through policy intervention, they would have to shift southern trade flows through three different types of trade intervention: bilateral, minilateral, or minimultilateral.

Bilateral Arrangements

Bilateral arrangements could involve across-the-board liberalization agreements or the exchange of concessions product by product. If the two parties are large players in each other’s markets, their bilateral trade could expand. And with a large number of such agreements, the potential probably exists for South-South trade to expand above its previous rate. Bilateral agreements, however, present two important problems. First, any arrangement involving only two countries has the potential to divert trade; that is, the trade prefer-
ences could cause high-cost imports to drive out low-cost imports from third countries. Second, the proliferation of bilateral agreements would expand the potential for trade diversion and make the process of negotiation and agreement extremely complicated and costly. Thus bilateral agreements lack two important benefits of multilateral arrangements. The first is access to least-cost suppliers. The second is a negotiating process that gives export lobbies the maximum potential stake in liberalization; with such a stake, exporters can more effectively counter pressures for import substitution.

Minilateral Arrangements

Developing countries in groups larger than two could make regional or non-regional minilateral arrangements. We have already seen that the extensively adopted regional variant has a poor record, but some analysts, including Lewis (1980), believe that it is potentially important. Lewis also hints at the possibility of nonregional minilateral agreements that would build on the Protocol Relating to Trade Negotiations among Developing Countries promulgated by the General Agreement on Tariffs and Trade (GATT) in 1973. This could be thought of as a South-South Global System of Trade Preferences (GSTP).

In 1986, the Group of Seventy-Seven concluded an agreement that provides a legal framework for a South-South version of the trade preferences currently being negotiated under the aegis of the United Nations Conference on Trade and Development. The fifteen years of experience with the North-South Generalized System of Preferences has created widespread dissatisfaction. What was envisaged as a general preference scheme has fragmented into separate schemes riddled with exclusions, limitations, and discrimination (see Langhammer and Sapir 1988). A South-South scheme might succeed where the North-South arrangement failed if, as simulations by Erzan, Laird, and Yeats (1988) indicate, the benefits could accrue to southern countries. The internalized benefits would minimize the dangers of fragmentation. But as the simulations of Erzan, Laird, and Yeats also indicate, the developing countries are heterogeneous, are at varying levels of development, and have conflicting trade interests; these characteristics would impede any adjustment. The simulations show that the principal benefits of a southern GSTP are skewed toward Asian developing economies, including the NIEs, and away from Africa; indeed, the trade balance of the African region would deteriorate. Nonetheless, Erzan, Laird, and Yeats argue that such a GSTP could benefit developing countries as a whole: if, for example, the GSTP offered a 50 percent preference margin to imports from developing countries, South-South trade would expand by 8.5 percent a year. This rate of growth presumes, however, the elimination of all nontariff barriers and still yields only a 1.5 percent annual growth in total southern trade.

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Minimultilateral Arrangements

A southern free trade area, essentially the expansion of minilateral arrangements, has gained the support of a number of influential commentators, including Gray (1985) and Lewis (1980). This is a radical option, and its proponents recognize that it would require new institutional arrangements such as a clearing body and an explicit compensation scheme for redistributing income from gainers to losers (with the latter presumably being exporters of primary products). In a sense this is the first-best of the second-best options.

This is so because, although South-South discrimination is inferior to multilateral free trade, multilateral South-South free trade is likely to be superior to any of the other options described here: it would include all southern countries, thereby maximizing the potential for trade creation, and in principle it could be accommodated by GATT and the International Monetary Fund. Simulations involving a southern free trade area (Erzan, Laird, and Yeats 1988) show, not surprisingly, that 100 percent tariff preferences produce the most significant changes in trade. Thus, if supply is unconstrained, South-South trade expands by $14.3 billion\(^4\) a year, a rate about 17 percent above current levels, or 3.3 percent of current total trade. Moreover, almost three fourths of this increase is attributable to trade creation and only about one fourth to trade diversion.

The South-South free trade option could be combined with explicit discrimination against (delinking from) the North. Simulations by Mercenier and Waelbroeck (1986) suggest, however, that the gains from South-South free trade would not be significantly augmented by delinking, even when the effects of possible retaliation by the North are ignored (see table 5 and compare regime 1 with regime 2).

A southern free trade area is politically the most problematic of the options discussed. Some developing countries are oriented strongly outward and would find the transition easy to make; but many more are oriented strongly inward and would find the required commitment extremely difficult to undertake, as the experience with regional trade associations, often involving a relatively small number of countries, demonstrates. For example, the East African Community, which involved only three contiguous countries at similar stages of development and with strong historical links, collapsed under the strains of tensions over redistributional arrangements. Beyond these problems lies the danger that southern retrenchment into a South-South free trade area would be met by further movement toward a North-North free trade area, a development that can hardly be in the interest of either group.

Multilateral Trade Expansion and GATT

As we have seen, the repeated calls for South-South trade expansion are often in large measure motivated by politics rather than by rigorous economic
Table 5. Estimated Short-Run Effects on Southern GDP of Selected South-North Trade Policies
(percent change from 1980 GDP at constant factor prices)

<table>
<thead>
<tr>
<th>Regime</th>
<th>1&lt;sup&gt;a&lt;/sup&gt;</th>
<th>2&lt;sup&gt;b&lt;/sup&gt;</th>
<th>3&lt;sup&gt;c&lt;/sup&gt;</th>
<th>4&lt;sup&gt;d&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Delinking</td>
<td>Minilateral liberalization</td>
<td>Nonreciprocated multilateral liberalization</td>
<td>Reciprocated multilateral liberalization</td>
</tr>
<tr>
<td>Developing country group</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Low-income oil importers</td>
<td>0.41</td>
<td>0.64</td>
<td>0.87</td>
<td>0.96</td>
</tr>
<tr>
<td>Africa</td>
<td>0.26</td>
<td>0.56</td>
<td>0.98</td>
<td>1.10</td>
</tr>
<tr>
<td>South Asia</td>
<td>0.45</td>
<td>0.66</td>
<td>0.85</td>
<td>0.93</td>
</tr>
<tr>
<td>Middle-income oil importers</td>
<td>2.73</td>
<td>2.31</td>
<td>1.91</td>
<td>2.55</td>
</tr>
<tr>
<td>Africa</td>
<td>1.50</td>
<td>1.26</td>
<td>1.05</td>
<td>1.47</td>
</tr>
<tr>
<td>East Asia</td>
<td>4.05</td>
<td>4.41</td>
<td>5.05</td>
<td>5.88</td>
</tr>
<tr>
<td>Latin America</td>
<td>2.20</td>
<td>1.67</td>
<td>1.08</td>
<td>1.82</td>
</tr>
<tr>
<td>Higher-income oil importers</td>
<td>2.95</td>
<td>1.98</td>
<td>0.88</td>
<td>1.55</td>
</tr>
<tr>
<td>Latin America</td>
<td>2.57</td>
<td>2.18</td>
<td>1.79</td>
<td>2.37</td>
</tr>
<tr>
<td>Southern Europe</td>
<td>0.08</td>
<td>0.00</td>
<td>-0.11</td>
<td>-0.10</td>
</tr>
<tr>
<td>Developing OPEC</td>
<td>0.09</td>
<td>0.04</td>
<td>0.01</td>
<td>0.07</td>
</tr>
</tbody>
</table>

GDP = gross domestic product.
OPEC = Organization of Petroleum Exporting Countries.
Note: Figures reflect short-run effects of policy changes, where the result is not affected by induced changes in the capital stock.
<sup>a</sup> 50 percent cut in tariffs on imports from the South and 50 percent increase in tariffs on imports from the North.
<sup>b</sup> 50 percent cut in tariffs on imports from the South.
<sup>c</sup> 50 percent cut in tariffs on all imports.
<sup>d</sup> Regime 3 plus 50 percent tariff cut by the North.

Source: Mercenier and Waelbroeck 1986.

analysis. And the many discriminatory South-South trading arrangements have absorbed real resources in their negotiation and operations while falling far short of their goals.

Experience and theory suggest that the GATT rounds of multilateral trade negotiations offer southern policymakers a relatively high potential for solid trade gains compared with a southern union. Developing countries have rightly seen that the GATT system has not worked to their advantage and has often been little more than a forum for periodic negotiations among the power players—the EC, Japan, and the United States. The developing countries, however, have exerted some influence on the GATT: the introduction of part IV, which is specifically written to benefit developing countries, resulted from concerted pressure by the South; and the avoidance of an explicitly discriminatory article on emergency actions against imports (article XIX) in the Tokyo Round...
occurred at least in part because of southern opposition. Greater concerted action would hardly be sufficient to the task or even possible given divergent interests among developing countries. Nevertheless, full involvement in the Uruguay Round and a greater commitment to the GATT would, in the long run, yield returns higher than those likely to flow from a preoccupation with negotiating arrangements to encourage South-South trade expansion.

This follows, first, from theory. Global liberalization allows countries to specialize in accordance with comparative advantage. The relatively high current levels of protection in many developing countries (see Greenaway 1986) and the discrimination they face in northern markets in a range of commodities—particularly textiles and clothing, agricultural products, and simple manufactures (Nogués and others 1986; Laird and Nogués 1988)—imply substantial gains from further multilateral liberalization.

Second, beside theory lie the opportunities inherent in the current state of world trade, as shown in empirical work, and the opportunities in the current state of the GATT process. Empirical work supports the view that multilateral liberalization will yield gains in trade and production that will exceed those from minilateral trading arrangements of whatever form. In an evaluation of trade liberalization in ten Asian countries, De Rosa (1988) estimates that the welfare gains from global most favored nation tariff reduction by these countries under GATT agreements would be about eight times the gains from equivalent regional trade liberalization and more than five times the gains from equivalent southern liberalization (see also Mercenier and Waelbroeck 1986 and Laird and Yeats 1988). Table 5 shows that multilateral liberalization by the South (regime 3) is superior even in the short run for the many developing countries that are low-income oil importers. With this policy action, moreover, comes the greater possibility of reciprocated action by the North—regime 4 in table 5—which is projected to produce even larger gains across the board. This finding is supported by Laird and Yeats (1988), whose simulation of nontariff-barrier liberalization shows these gains to be particularly large in textiles, clothing, footwear, and foodstuffs.

The GATT process offers unprecedented opportunities because to an increasing degree developing countries individually and in groups have something with which to bargain, namely improved access to their markets. The large industrialized economies see improved market access, to the NIEs in particular, as an important issue of principle and could well offer major concessions in exchange for it. At the same time, for many developing countries, liberalization no longer holds the horrors it once did, given the perceived benefits of enforced liberalization under the structural adjustment loan programs.

Also, the GATT negotiations are now being extended to services. As Bhagwati (1987) points out, the larger NIEs already find that international payments for services are generating only small deficits, or even small surpluses. Moreover, the developing countries generally possess relatively cheap human capital, a situation that offers the potential for expansion of exports. In short,
the South has more to gain than to lose from reaching an agreement on services.

In summary, South-South trade is most likely to grow within a multilateral context, as part of the process of multilateral (North-South, North-North, and South-South) trade expansion rather than separately from it.

Notes

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The authors would like to acknowledge comments on an earlier draft from John Black and two anonymous referees.

1. The composition of the group of NIEs is by necessity somewhat flexible. The obvious member economies are Hong Kong, Korea, Singapore, and Taiwan. Countries such as Argentina, Brazil, and Mexico are also usually included. But Havrylyshyn and Alikhani (1982, 1989) show that a new tier of NIEs has emerged as exporters of manufactures; this group includes such countries as Colombia, Malaysia, Morocco, the Philippines, Thailand, and Tunisia.


3. From factor proportions theory we would expect also that exports from more advanced to less advanced developing countries will be more capital intensive than exports from advanced developing countries to industrial countries. The little evidence that exists provides support for this proposition. Havrylyshyn (1985) and Havrylyshyn and Wolf (1983), using a sample of forty-five developing countries for the period 1963-78, provide strong evidence that South-South trade is generally more capital intensive than South-North trade.

4. One billion equals 1,000 million.

References

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