Comment on "Integration of Trade and Finance in Africa," by William Lyakurwa

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Introduction

This is an interesting and informative paper combining a nice mixture of normative and positive economics. The paper is divided into two related parts: first, it contains a general discussion of regional trading arrangements (RTAs) in Africa and provides some empirical evidence on the trade potential in these arrangements. And second, it looks at the relationship between RTAs and foreign direct investment. This latter part of the paper is relatively new, in that this issue has not been hitherto rigorously examined when considering the issue of RTAs. This comment can be conveniently divided in a similar way.

Regional Trading Arrangements: General Aspects

It is widely accepted that the first-best trade policy is liberalisation on a most-favoured nation (MFN) basis. When a country chooses to participate in an RTA, it should do so in a manner that is compatible with the process of multilateral trade liberalisation.[2]

The paper accepts this general view, arguing that RTAs in Africa indeed have the objective of trade liberalisation, first among members and then between the group and the rest of the world. It then goes on to say that RTAs can be quite successful in increasing intra-regional trade. This is a somewhat controversial conclusion, and there are several issues and questions that can be raised about the analysis that supports this conclusion.

First, in discussing the "success", or lack thereof, of RTAs in sub-Saharan Africa (SSA), the author does not seem to make a distinction between two kinds of success/failure: (i) failure of completed regional trade

1 The views expressed here are the sole responsibility of the author and do not necessarily reflect the opinions of the International Monetary Fund.

2 As a minimum, RTAs should be consistent with the obligations of GATT Article XXIV. These obligations include, among others, that substantially all trade among members be liberalised, that extra-regional trade barriers not be raised, and that these arrangements be notified to the World Trade Organisation.

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liberalisation to produce regional economic benefits; and, (ii) failure of a regional liberalisation initiative to achieve substantive regional liberalisation. The two are not the same. The former would attempt to say something about the expected welfare consequences of regional integration, while the latter would look at the political economy of regional integration initiatives in SSA.

Second, what is important in terms of prescriptive public policy analysis is not an estimate of the potential for expanding intra-regional trade, but some indication of the associated welfare effects. At times, it seems that the author simply equates increased intra-regional trade with increased prosperity.

Third, regarding the proposition that RTAs can help to lock-in trade reforms and that unilateral reforms have been time-inconsistent, it should be pointed out that the multilateral trading system also offers policymakers a chance to lock-in trade reforms through tariff bindings. The question is why countries of SSA appear to be able to make regional trade liberalisation commitments that they cannot make multilaterally. One answer is that many of these regional commitments are not typically kept, or they are delayed over long transition periods, or in practice they cover only a limited amount of total external trade as intra-regional trade in Africa is generally low.

Finally, the author discusses the possible need to provide, in effect, "side-payments" to entice partners to join the RTA. However, there is no explanation why some countries would be willing to pay these, apart from the case when they expect to benefit from trade diversion. Can one argue that this was why South Africa agreed to a formula to redistribute SACU tariff revenues that benefitted its neighbours? Might the prospect of such side-payments stimulate rent-seeking by some potential members and possibly inhibit the formation of RTAs?

To provide empirical estimates of trade potential in the various RTAs currently in place in Africa, the author estimates a standard gravity model of bilateral trade flows augmented by dummy variables for eight regional integration arrangements in SSA. A positive and significant coefficient on these dummies – obtained in four of the eight cases – is interpreted as evidence of "significant trade potential" within that regional arrangement. In my view, such an interpretation is not necessarily correct. "Trade potential" is a dynamic, forward-looking concept that either takes as a benchmark the prediction from a well-structured trade model (say, the standard Hecksher-Ohlin model), or that tries to capture in some way the efficiency/trade gains from: (i) the elimination of trade distortions; and/or (ii) the expansion of the market size. It is difficult to argue that the dummy variables in the regression are capturing any of these effects, especially

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since the coefficients are obtained for a period where the regional integration attempts were plagued with serious deficiencies – in terms of their overall orientation and incentive structure. In fact, I would argue that the "trade-enhancing" effects that the four arrangements where the dummy coefficient was significant appear to have had were not welfare-enhancing, as they are likely to have fostered the "wrong-type" of trade. One has to be careful with this type of analysis, since econometric evidence of trade potential does not separate "trade potential" which derives from trade *diversion* from that which derives from trade *creation*. Because most SSA countries maintain rather high external tariffs, the potential for trade creation – increasing intra-regional trade – may be well high, but increased trade may equally well represent trade diversion, i.e., a shift in consumption patterns from low-cost to higher-cost suppliers.

RTAs and Foreign Direct Investment

The paper also makes a novel argument in favour of RTAs, namely that they may lead to an increase in foreign direct investment (FDI). To date, Africa has received a very small share of FDI going to developing countries. For example, between 1990 and 1995, all developing countries received approximately $245 billion of (net) FDI. For the same period, Africa only received $10 billion. The 1996 net FDI to developing countries is projected to be around $55 billion, with Africa getting about $3 billion. Clearly, any measures that increase Africa's share in the flow of FDI would be of enormous benefit to the continent.

Are RTAs a way of generating an increase in FDI? The author basically relies on an extension of the argument that FDI has tended to go to larger markets. An RTA is undoubtedly a larger market, and this should benefit FDI. But at the same time, a larger market is only one – and by no means the most important – factor influencing FDI. Many other factors are important, including macroeconomic stability, currency convertibility, political stability, favourable rates of return, and flexible labour markets, to mention a few. In general, FDI has proved to be notoriously difficult to explain, let alone model in an acceptable fashion.

The author does make a brave attempt at modelling the relationship between RTAs and FDI in Africa, but does not control for the myriad other factors driving FDI to developing countries. Two specific points are worth making regarding these empirical estimates.

First, due to lack of data, the author uses (the log of the decadal average of) manufactured exports as a proxy for intra-regional trade flows. It is apparent that the correlation between these two variables cannot be taken for granted. It is not fully clear why the author opted for focusing on the

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"manufactured" dimension of intra-regional exports over the "intra-regional" dimension (on which he had the data that was used in the estimates of trade potential); be it as it may, the author needs to provide some evidence in support of the existence of a relation between manufactured exports and intra-regional trade in SSA.

Second, the conclusions from the empirical results on the relation between exports and foreign direct investment (FDI) need to be stated more cautiously. The coefficient of the ratio of FDI to GDP has the wrong sign! As such, it is not particularly meaningful to interpret too strongly the significance and sign of the interaction between FDI and education.

Conclusions

In summary, I feel that the paper makes an interesting start in looking at how RTAs could be helpful in attracting foreign direct investment to Africa. Intuitively, this idea makes a lot of sense. The author should also be commended for pushing the argument further by providing empirical tests of the hypothesis. While the results are weak, they nevertheless represent a useful beginning. Africa has to attract foreign direct investment and RTAs may be a way to do it, providing of course, the other factors typically affecting foreign direct investment are playing their respective roles. In that sense, the paper does have considerable policy relevance. At the same time, should one be optimistic about the future success of RTAs in Africa? The author's own brief description of the history of such arrangements says otherwise.

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