

Chapter 1

Trade integration, production networks and the services sector: implications for regional trade agreements in Eastern and Southern Africa

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1. Introduction

Regional economic integration in Eastern and Southern Africa has been beset for years by problems relating to overlapping membership of sub-Saharan African regional groupings, lack of political will and institutional capacity, and tensions between intra-African (SACU, SADC, COMESA) agreements and trade agreements concluded either individually or collectively with extra-continental countries or blocs (such as the SA-EU TDCA, SACU-US FTA negotiations, AGOA and the ongoing EPA discussions with the EU). SACU itself has been involved in Free Trade Agreement (FTA) negotiations on several fronts, as well as multilateral trade discussions under the auspices of the WTO.

A suitable framework for regional integration in sub-Saharan Africa has long been debated. Since the mid-1990s the analysis has escaped the confines of the basic orthodox trade creation/trade diversion framework, with recognition of its limitations in the developing country context. A development integration approach has been contemplated, in which economic integration is seen as a vehicle for regional industrial development through, for example, a lowering of the costs of protecting the industrial sector, making use of the advantages of a larger regional market, and cooperation in transport and infrastructural development. In this regard, literature on the region began to consider aspects such as economies of scale, dynamic effects including the impact on investment and the polarisation of industrial development, as well as fuller analyses of mechanisms to facilitate an equitable distribution of the costs and benefits of regional integration among countries at unequal levels of development.¹ Exploration of the lessons of the new trade theory, such as the benefits of intra- versus inter-industry specialisation, has also begun.² Recent contributions on African economic integration have nonetheless criticised the region's

¹ See, for example, Mutambara (2001) and McCarthy (1999).

² Cattaneo and Fryer (2002); Visser (2001b); Visser and Hartzenberg (2004); Petersson (2002, 2003, 2005).

adherence to a linear model of regional integration, proceeding from a free trade area to a customs union, common market and finally economic union, notwithstanding the variable geometry approach built into the system (McCarthy 2007).

These developments have still largely focused on trade in final products.³ However, a significant amount of trade expansion in recent years has been in 'fragmented trade', with the exchange of intermediate and unfinished products comprising as much as 30% of global manufacturing trade. In some countries, growth in such trade exceeds that of trade in final goods, and interest is growing in cases where it has a regional dimension, such as East Asia (Haddad 2007:3; Athukorala 2005; Arndt 2004b). Important questions include what the benefits might be for African developing countries of intra-product specialisation and trade expansion related to the international fragmentation of production, and whether such benefits may be greater, or better harnessed, in a context of regional integration. Whether the integration context is one of a North-South or South-South preferential trading arrangement and, in particular, one between countries at unequal levels of development will also be important. The first aim of this chapter is thus to provide a synthesis of the theoretical literature on the international fragmentation of production and regional integration, and to explore the implications of this body of work for the sub-Saharan African integration context.

The theoretical analysis of fragmented production distinguishes between production blocks or segments (i.e. the different parts of the production process) and the service links required to coordinate these blocks (Petersson 2003: 763-764). An important reason for the growth of the fragmentation of production as an international phenomenon is the reduction in the cost and the improved reliability of these service links internationally. Countries involved in international production networks therefore require services sectors that efficiently support and facilitate manufacturing (Van Long et al. 2001:1). In this regard, and in the light of the increasing importance of the services sector as a proportion of Gross Domestic Product (GDP) in developing countries and the growth of trade in services, the implications of services liberalisation under the General Agreement on Trade and Services (GATS) aspects of the regional integration agreements need to be explored. The second purpose of

³ Exceptions include Petersson (2003) and Visser (2001a,b).

the chapter is therefore to highlight the importance of the services sector in manufacturing production and trade, and in this regard to examine the growing literature and debates surrounding the services aspects of regional integration agreements in a developing country context.

The rest of the chapter is organised as follows. Section 2 considers why firms engage in production sharing, and why this phenomenon has acquired an international dimension, leading to fragmented trade. Section 3 explores fragmented trade from a regional perspective. In particular, it examines whether the potential benefits of intra-product specialisation may be more readily attainable through preferential trade agreements (PTAs), especially in the developing country context. More specifically, it considers the implications in the case of regional groupings like SACU and SADC, whose member countries differ significantly in size and level of development. Section 4 highlights the importance of the services sector in production sharing and fragmented trade, while Section 5 explores how services aspects of regional trade agreements (RTAs) can be used to support this role. The concluding section contemplates the implications of the analysis for regional integration policy in Southern Africa. The significance of North-South versus South-South PTA contexts will be explored in this regard.

2. Production networks and fragmented trade

Production sharing

Production sharing, or fragmentation of the production process, takes place when the stages of production of a commodity are separable into different production blocks. Production stages may then take place at different locations, although the production blocks require coordination through service links. Such links include transport, communications, insurance, quality control, and managerial coordination (Arndt and Kierzkowski 2001:4).

Figure 1: A simple example of fragmented production

Input	→	Production block 1	→	Service link	→	Production block 2	→	Markets
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Source: Arndt and Kierzkowski (2001: 4)

Fragmented production allows intra-product specialisation, where the factor intensity of the component rather than that of the final product, is relevant. Production at each stage can consequently take place in the lowest cost location. In addition, manufacturers may be able to take advantage of scale economies at the component level, for example by supplying numerous final good producers. Such advantages would not be available in an integrated production process. Further, since intra-product specialisation is a form of intra-industry specialisation, some of the benefits of the latter, such as lower adjustment costs when resources are reallocated, may also be forthcoming. These potential advantages are explored in more detail below.

The availability, cost and efficiency of the service links that coordinate production blocks are clearly critical to the extent of fragmentation. Due to the importance of these links, production sharing was until recently predominantly domestic rather than international in nature. Local service links were less costly and proximity was important in keeping coordination costs low (Petersson 2003:764). However, production sharing across borders has been stimulated by a number of factors. These include liberalisation of trade in goods and services, technological advances, especially in information and communication technologies, and greater compatibility in legal and regulatory frameworks across countries (Arndt and Kierzkowski 2001:4).

Fragmented trade

As a consequence of the above factors, cross-border production sharing has become widespread (Feenstra 1998). Intra-product specialisation across national boundaries has led to trade in intermediates in accordance with comparative advantage, known as fragmented trade. The latter adds to total trade since each component becomes a separate constituent of global trade. It has been estimated that trade in components has grown significantly faster than trade in final goods in some regions, and now accounts for 30% of manufacturing trade (Haddad 2007:3).

Such fragmented trade may take place within a particular firm (intra-firm trade) or between different firms. It has been found that the activities of multinational corporations (MNCs) alone cannot explain the growth and importance of cross-border production sharing (Arndt and Kierzkowski 2001:9). If separate production blocks are accompanied by separation of ownership, then foreign direct investment (FDI) will be less important. Without ownership separation, MNCs and FDI will be more predominant in production sharing; however, neither is necessary *per se* for the phenomenon to occur.

The important question for the purpose of the present chapter is whether the phenomenon of fragmented trade provides benefits or opportunities for developing countries, either in the aggregate welfare sense or in terms of distributional effects, which differ significantly from those suggested by conventional trade theory and its extensions. The rest of this section explores this issue in the context of trade theory more generally, while Section 3 specifically considers fragmented trade in the regional integration context.

In the Heckscher-Ohlin framework, trade in components will be driven by differences in factor endowments between countries and differences in the factor intensities of the production process in each production block. The difference is that the division of labour and specialisation will occur at the level of components rather than of final products. This specialisation will tend to be welfare-enhancing at the aggregate level. However, in addition, the location of component and final good production will now depend on the relative cost and efficiency of the international service links connecting the production blocks, as well as on the usual Heckscher-Ohlin considerations. This aspect is considered further in Section 4.

Of relevance to developing countries like South Africa is that production sharing offers potential opportunities for higher wage producers of labour-intensive goods to improve industry competitiveness by giving up local production of the most labour-intensive industry components (Arndt and Kierzkowski 2001:6). This could counter the usual adverse employment, output and wage implications of trade liberalisation (whether regional or multilateral) for such sectors. In addition, with intra-sectoral resource reallocation, short term costs of adjustment may be mitigated. This is in line with the view that factors of production are likely to be more mobile between the

production of goods within an industry than between the production of goods in different industries (Cattaneo and Fryer 2002:19). In the context of vertical specialisation, however, the applicability of the so-called 'smooth adjustment hypothesis'⁴ depends on how significantly factor requirements differ between the various production blocks.

Another important aspect is that the opportunities for benefiting from economies of scale are extended in the context of fragmented production and trade. If components can be provided to both domestic and international end-good producers, scale economies can be reaped at intermediate stages of production rather than only at the final product stage. In addition, Jones and Kierzkowski (2001:24) argue that the service links that coordinate production blocks are themselves characterised by significant increasing returns to scale.

The implications of fragmented production and trade for development through industrialisation warrant careful consideration. Arndt and Kierzkowski (2001:7-8) argue, for example, that intra-product specialisation 'broadens the choice of development strategies and generally reduces the hurdles to be overcome in the quest for industrialization'. The reasoning is that, given the benefits of component specialisation, developing country producers need not become adept at all stages of the production chain in order to break into world markets. Developing country firms could begin by specialising in more labour-intensive processes, while developing capabilities in more capital and skill-intensive stages of production. Size advantage could become less important, with small and medium-sized firms competing more readily with MNCs. Firms can save on learning costs as well as benefit from knowledge transfers by engaging in international production sharing. Intra-product specialisation may thus facilitate earlier participation in global industries than would otherwise have been the case.⁵

⁴ See Brühlhart (1999, 2001).

⁵ See Ruane and Görg (2001) on implications for developing countries of their study of the Irish electronics industry, which was identified as a target for industrial policy because of the increasingly fragmented nature of production processes in the sector.

3. Production sharing and fragmented trade in the regional integration context

Growth in fragmented trade has often had an important regional dimension, particularly in East Asia. The essential question for the SADC region is whether the potential benefits of intra-product specialisation may be more readily harnessed through Regional Trading Agreements (RTAs), especially in the developing country context. Another important question is whether participation in RTAs which *actively promote* production sharing arrangements can mitigate some of the potential adverse effects of regional integration – such as trade diversion and polarisation of industrial development – amongst countries at unequal levels of development.

As in the case of trade theory more generally, the theoretical rationale for economic integration, both in terms of static and dynamic effects, has largely been analysed with reference to trade in final products. Once fragmented production and trade are recognised or encouraged, however, the potential effects of PTAs and deeper forms of regional integration will differ from the conventional ones. The implications of production sharing and fragmented trade in the context of economic integration may be considered with reference to static trade creation and trade diversion effects, economies of scale, investment effects and polarisation.

Trade creation and diversion effects

The static welfare effects of economic integration in the presence of production sharing have been extensively analysed by Arndt (2001, 2003, 2004a,b). The orthodox theory of customs unions examines the welfare effects of economic integration in terms of the balance between trade creation (the replacement of relatively inefficient domestic production by lower-cost imports from a partner country) and trade diversion (the replacement of lower-cost imports from the rest of the world with relatively higher-cost imports from a partner). A free trade area or customs union is considered to be beneficial when the former effect dominates. The traditional analysis has been criticised for its limited applicability in the developing country context (Jaber 1970; Cattaneo 1998); however, extensive use is still made of these concepts in empirical work on both North-South and South-South RTAs.

Arndt (2001) compares the introduction of intra-product specialisation (i) in the absence of trade restrictions, (ii) in a context in which MFN tariffs are applied, and (iii) in the context of preferential tariffs. In the first case (the free trade context), welfare increases unambiguously with the introduction of production sharing, while in the second case (that of most favoured nation – MFN – tariffs) welfare may rise or fall depending on the magnitude of the distortion due to the tariffs in comparison to the efficiency gains resulting from intra-product specialisation.⁶ However, when production sharing is introduced in the context of a preferential tariff arrangement (such as an FTA or customs union), it is shown that welfare unambiguously rises compared to a preference situation in which production sharing is absent (Arndt 2001:80-82). The introduction of production sharing into the trade creation/trade diversion framework thus mitigates any trade diversion consequences of integration.⁷

Arndt (2003:5) illustrates the argument with reference to changes in trading patterns in the auto sector following the formation of North American Free Trade Agreement (NAFTA). In the conventional framework, shifts in US motor vehicle imports away from non-NAFTA members (say, Japan) towards Canada and (in particular) Mexico could be interpreted as trade diversion. However, in the context of a preferential trade regime characterised by production sharing, imports of Japanese motor vehicles (produced entirely in Japan) into the US could be replaced by imports of vehicles from Mexico containing US-manufactured components, where Mexico is specialising in labour-intensive assembly and the US in components in which it has a comparative advantage. Production sharing between the US and Mexico facilitates factor cost savings of sufficient magnitude to reduce trade diversion to production in which Japan's cost advantage in the final product translates to all constituent processes.

Allowing for production sharing and fragmented trade in the static trade creation/trade diversion framework therefore increases the opportunities for welfare-enhancing FTAs. In addition, trade creation need not lead to the loss of domestic industry in a given sector, a consideration often raised in the development literature

⁶ The effect of intra-product specialisation on a country's labour-intensive import-competing industry X is similar to the case of technical progress in that the production possibility frontier moves outwards along the X-axis (see Arndt 2001:78, 86).

⁷ If the home country is large in the PTA context, there will be a terms of trade effect that will augment the rise in welfare.

on economic integration. If there are two components associated with the production of a given final product, for example, intra-product specialisation may enable both partners to retain production blocks within a given industry, although resource reallocation between blocks within the industry will be necessary. As noted in Section 2, the literature on intra-industry trade suggests that such resource reallocation will be less exacting than in the inter-industry case.⁸

Arndt (2001, 2004a) cautions, however, that potential cost savings from intra-product specialisation may be lowered by restrictive rules of origin in the case of a free trade area. The example given is of rules that divert component sourcing from lower-cost non-FTA countries to higher-cost FTA partner countries. Rules of origin need to be designed in such a way that they fulfil their actual purpose of preventing trade deflection (whereby non-member countries access higher-tariff FTA member country markets via lower-tariff FTA member countries), without being used to hinder intra-regional trade and participation in global trade and production networks (Brenton et al. 2005). This aspect is considered further in the SADC context in Section 6.

Economies of scale

A major motive for trade integration among developing countries has been the possible exploitation of economies of scale in a larger regional market. Where economies of scale are internal to the firm, a larger regional market will result in benefits from falling average costs as firms move down their cost curves. It has been debated whether the enlarged market in an RTA between countries of unequal size or levels of development where internal scale economies are important, will mainly benefit producers in larger countries (such as South Africa in the SADC context), who may capture the entire regional market.⁹ In a study of economies of scale and economic integration in Latin America, Cline (1982), however, argues that smaller countries, by producing for their domestic markets at below minimum optimal scale, stand to gain significantly from regional economies of scale because of the higher excess cost they incur compared to large countries.

⁸ It needs to be borne in mind throughout this discussion that the ability to reap the benefits of intra-product specialisation ultimately rests on the cost and efficiency of the service links that coordinate production blocks, whatever the context. The matter of the service links is considered explicitly in Section 4.

⁹ See the discussion in Cattaneo (1998:116-119).

The introduction or promotion of production sharing and fragmented trade within the regional grouping will enhance the opportunities for benefiting from regional economies of scale, provided these economies are production block specific. As noted in Section 2, intra-product specialisation and trade provide room for exploiting economies of scale at intermediate stages of production, as well as at the final product stage. It may be easier, in particular, for smaller, more labour abundant countries within a regional group to specialise in more labour-intensive components to serve the regional market and so obtain benefits from regional economies of scale before attempting to break into less accessible global markets.

Polarisation

Economies of scale may be external to the firm or production block, and it has been argued that the exploitation of dynamic economies of scale in a larger regional market may lower the costs of infant industry protection during the learning period and allow optimum capacity to be reached in a shorter period of time (Lundahl and Petersson 1991:197-198). It has further been argued that dynamic economies of scale may provide a case for regional integration among countries at unequal levels of development, since favourable spread effects may be induced from the more advanced centres to the less developed regions and to the integrated area as a whole (Lundahl and Petersson 1991: 202). In the context of fragmented production, any such benefits will be strongly dependent on the cost and efficiency of the service linkages between production blocks. In addition, it is widely argued that any favourable dynamic effects from integration may be outweighed by adverse polarisation effects for some members of a regional grouping among countries at unequal levels of development (Vaitsos 1978:739; Robson 1987:169-175). The issue of polarisation has indeed been a prominent theme in the literature on the effects of trade integration in Southern Africa.

Krugman's (1991:96-97) analysis suggests, however, that polarisation is not inevitable, as there is a U-shaped relationship between economic integration (taken to be the absence of transport costs and barriers to trade) and welfare in the peripheral areas of a regional union. This means that closer integration locates production in the periphery, but a limited move towards integration may concentrate industry at the core. Fragmented industrial production within a regional trade

arrangement could provide additional opportunities for limiting or mitigating polarised industrial development. Intra-product specialisation in more labour-intensive components in lower-wage locations could be promoted, but the cost of associated service links (especially transport and other non-tariff barriers) will be critical.

Investment effects

Provided that economies of scale are reasonably small and simple (so that polarisation is not exacerbated on that score) and that different regions within an RTA do have comparative advantages in different production blocks, polarisation seems less likely than it does under more conventional assumptions (that is, when fragmented production is not considered). Where possibilities are evident for production sharing, the investments needed to generate this production structure are likely to follow. Provided the service links can be guaranteed, the recognition that profitable opportunities exist in component production in peripheral areas should induce MNCs or local investors to invest. In RTAs between countries at unequal levels of development, the introduction of production sharing is likely to be accompanied by FDI flows to less developed member countries.

It has commonly been argued that FDI may be an essential catalyst for the dynamic benefits of economic integration identified in the regional integration literature (Blomström and Kokko 1997:12). In the SADC region, both intra-regional and extra-regional FDI flows would need to be encouraged because of domestic savings shortages in the national economies of the region. There could be particular advantages to attracting FDI from important outward investor developing countries like Brazil, which may have expertise in particular production blocks. It has been argued that South-South FDI may provide significant development benefits due to 'more appropriate technologies, business models, managerial and organisational techniques... better attuned to developing-economy circumstances' (Gammeltoft 2007:3). It has been found that FDI and fragmented trade are complementary in East Asia, and that FDI has been particularly important in explaining fragmented trade in that region (Haddad 2007; Aminian et al. 2007).

In concluding Section 3, it should be noted that while production sharing and fragmented trade may be a feature of economic integration blocs, and while the latter

may provide certain opportunities for benefiting from intra-product specialisation, formal economic integration is not a necessary condition for meaningful growth of the phenomenon. Indeed, in East Asia, although production sharing has a very strong regional dimension, it has developed largely outside formal economic integration arrangements, in contrast to production sharing in the NAFTA or EU regions. This is largely because of the 'naturally' low barriers and transport costs (essentially due to the efficiency of regional service linkages) between countries and the strong emergence of China as a low-cost assembler (Haddad 2007).

There are, however, clearly advantages to production sharing in the context of FTAs and customs unions, especially for countries of unequal size and levels of development. Policies would be needed to identify and target appropriate regional supply chains. Critical in the Southern African context is the issue of the service links required to facilitate production sharing. High costs and inefficiencies will diminish the advantages of regional production sharing in SADC. The following sections of this chapter explore the importance of these service links in supporting manufacturing production and trade, and investigate how their role can be harnessed in developing country RTAs.

4. The importance of the services sector in production sharing and fragmented trade

As noted in Section 1, an important reason for the growth of fragmented production and trade internationally has been the reduction in cost and improved reliability of the international service links required to coordinate production blocks. For developing countries to participate effectively in international production networks, it is therefore critical that manufacturing production and trade are supported and facilitated by an efficient services sector (Van Long et al. 2001:1). While there is a debate about the core role that the services sector should play in economic development, between those who argue that the sector itself should be the engine of growth and development and those emphasising its role in supporting and facilitating development through industrialisation,¹⁰ the focus in this chapter is specifically on the role of the services sector in fragmented production and trade.

¹⁰ For a sample of the debate, see Sheehan (2008), Dasgupta and Singh (2006), and Bell and Madula (2001).

Jones and Kierzkowski (2001:24) present two 'stylised facts' about the service links required to connect production blocks in the presence of fragmentation. The first stylised fact is that such service links within a country are cheaper than those required to coordinate production blocks across different countries. However, services trade has risen significantly, and services have themselves become subject to significant fragmentation and outsourcing. This suggests that a more nuanced view is necessary, regarding both the presumption that domestic service links are cheaper and fears that outsourcing of services may result in major job losses (Amiti and Wei 2004). It should also be noted that Amiti and Wei (2004:5) find that although services outsourcing is increasing rapidly, its levels are still low in comparison to production outsourcing.

The second stylised fact is that services exhibit strong economies of scale (greater than those that may be found within production blocks themselves). Once fragmentation expands across borders, strong service sector economies of scale come into play, reinforcing the expansion. Jones and Kierzkowski (2001) identify technological progress in the services sector as the key stimulation for international production fragmentation, coupled with the availability of better information about legal and regulatory frameworks. Other authors (such as Langhammer, 2006) emphasise services trade liberalisation and deregulation as the key to lowering the cost of 'intermediate' services in production chains.

Nordas (2001) investigates the impact of growth in the Information and Communication Technologies (ICT) sector on producer services (identified as transport, communications, finance and business services) in South Africa and, in particular, whether the development of the producer services sector has had a positive influence on growth and development elsewhere in the economy. She finds that the producer services sectors had markedly higher investment ratios, output growth and labour productivity growth than the economy as a whole in the 1990s. This provides an important potential source of growth and development for the economy, provided that sectors that use these services, such as the manufacturing sector, are able to take advantage of these developments. In particular, as argued in previous sections, efficient and cost-effective producer services are critical for manufacturers to participate in international supply chains. If, as Nordas (2001:10) suggests, South African producer services are becoming internationally competitive,

and are at least competitive within the SADC region, then the country could play a leading role in the development of regional production networks.

Whether Nordas' (2001) assessment is correct, the point is that it is necessary to assess exactly which services should be supplied within countries, which should be internationalised within SADC, and which should be sourced outside SADC. Criteria for this assessment include the importance of a particular service in the envisaged production chain as well as the existing or potential international competitiveness of service providers within SADC. For example, it might be that SADC-based financial services necessary for component production in Zambia could be developed to international standards within a decade. However, it still may be optimal, when the entire production chain is considered, to make immediate use of existing international suppliers rather than incur the costs of waiting for SADC-based suppliers to mature.

Langhammer (2006) provides an analytical framework and an empirical methodology that could potentially be developed into a method for assessing these criteria in the SADC case. He investigates whether the inefficiency of intermediate services causes 'developing countries [to] forego chances in world manufactured markets' (Langhammer 2006:2). The evidence presented is compelling. Firstly, manufacturing in developed countries seems to be considerably more service-intensive than in developing countries. Furthermore, service intensity increased in developed countries between 1990 and 2000, whereas it decreased in developing countries (Langhammer 2006:7). Although this particular implication is not discussed, Langhammer's argument is consistent with the argument that developed countries have been better able to capture the specialisation gains from fragmentation. In developing countries, low utilisation of service inputs presumably indicates that these services tend to be produced 'in house' rather than from specialised service providers.

Secondly, as mentioned above, Langhammer emphasises the regulatory environment as the key source of service sector inefficiency in developing countries. Langhammer (2006:8-11) estimates tariff equivalences for service sector taxation, and finds that both discriminatory and non-discriminatory (MFN) restrictions are much higher in developing countries. This is particularly so in telecommunications and financial services, the liberalisation of which seems to be an important factor in

fragmentation in developed countries. Consideration of which 'downstream' sectors (or, in our terminology, 'production blocks') are most affected reinforces the impression that careful reform of the services sector will be a crucial factor. As Langhammer (2006:14) puts it, 'service sector regulation and protection ... impedes just those [labour intensive] industries in the median developing country which are potential export industries. [The] situation is even worse in the service industries'.

5. Harnessing services aspects of regional integration agreements in support of the role of the services sector

If the promotion of production sharing and fragmented trade in a regional context is seen as desirable, how can the services sector best be promoted to support this? In Section 4 it was argued that both the growth and liberalisation of the services sector could stimulate international fragmentation, in conjunction with policies to attract suitable targeted investment. There has, however, been much debate about the pros and cons of services liberalisation in the developing country context. Important questions that follow are, firstly, whether services liberalisation in a regional integration context can address some of the concerns about developing country services liberalisation, or in some way contain the associated risks. Services provisions in RTAs are becoming widespread in both North-South and South-South regional agreements. The second important question for the purpose of this chapter is thus whether services aspects of RTAs can be used to support the role of the services sector in production sharing and fragmented trade in a developing country context.

In much of the burgeoning services literature, the benefits of generalised services liberalisation seem simply to be assumed without question. However, Lintjer (2002) has cautioned that the consequences of hasty or poorly-sequenced liberalisation of services could be severe for the sector itself and the macroeconomy in general. Although Langhammer's (2006) analysis, for example, suggests that deregulation in banking and telecommunications in particular would yield major gains by enhancing fragmented value chains, there are two important grounds for caution. Firstly, protection and regulation are not the only reasons why services are underdeveloped in developing countries. Huang (2002), for example, argues that the primary reason for low profitability and hence low rates of investment, in developing countries is a system-wide coordination failure. It follows that thoroughgoing liberalisation (for

example through extensive 'horizontal' commitments in GATS), even if it was politically feasible, would not necessarily result in investment flowing to the critical service link. Reliance on foreign supply of services (including FDI into domestic services industries) and over-commitment in GATS offers could also result in an erosion of what Wade (2003) calls 'development space'.

This leads to the second point, which is the question of the coordination of the development of entire fragmented production chains. In particular, a coordinating agent is necessary to target dynamic advantages that do not translate into immediate profitability. The essence of coordination failure is that none of the elements in a production chain would achieve their potential unless all of the other elements in the chain have already achieved theirs. This implies that liberalisation should be carefully targeted (taking advantage of the possibility of making sectoral commitments in GATS – see below). It also implies that priority should be given to the formulation of a holistic industrial policy for the region (Chang 2005), which takes into account fragmented production and the importance of service linkages.

Services liberalisation at the multilateral level is governed by the General Agreement on Trade in Services. For a variety of reasons liberalisation of services is recognised as being more complex and sensitive than goods liberalisation. Two key points are, firstly, that because proximity is often required between producer and consumer, international transactions require either producer or consumer to move, or capital to flow to invest in service activities (Stephenson 2002: 2). This leads to the GATS 'modes of supply' classification.¹¹ Secondly, restrictions are largely non-tariff barriers of a kind that are often deeply embedded into national policy frameworks, including national regulations, administrative controls and national laws (Stephenson 2002:2).

GATS contains two types of obligation or discipline. General obligations include MFN treatment and transparency, while specific obligations are national treatment and market access. The latter are specific to service sectors included in a country's schedule of commitments. A full analysis of the shortcomings and concerns about

¹¹ Four modes of supply are identified: Mode 1: Cross-border supply: non-resident service providers supply services across borders into a member's territory; Mode 2: Consumption abroad: member's residents purchase services in another member country; Mode 3: Commercial presence: service suppliers from abroad establish, operate or expand commercial presence (such as a branch or subsidiary) in a member's territory; Mode 4: Presence of natural persons: foreign persons enter and temporarily stay in a member's territory in order to supply a service (Fryer et al. 2005:23).

GATS is beyond the scope of this paper; however, Wade (2003:629) argues that the agreement makes it extremely difficult for countries to use a wide range of development policies available to successful developers in the past. While the benefits of GATS for developing countries include the important potential for increased FDI inflows, for example, Wade (2003:631) argues that there is not yet any evidence that GATS has raised such inflows. There are ongoing concerns about open financial flows and about pressure from developed countries for services market opening on the part of developing countries to further domestic developed country commercial interests with little cognisance taken of development concerns (Fryer et al. 2005; Wade 2003).

While South Africa and Lesotho's commitments under GATS are already comparatively far-reaching (Mene 2008; Manduna 2005), Mauritius' more cautious approach, discussed in Dabee, is interesting to consider. According to Dabee (2000:4), Mauritius' 'limited liberalisation is consistent with the development objectives of the economy'. There were carefully considered and targeted limitations in tourism (where policies were designed to maintain the quality of the country's tourism provision) and financial services (where there was acknowledgement of the potential dangers of financial liberalisation in such small economies). The study suggests further targeted liberalisation and possible new commitments (for example, in some aspects of computer and related services) which take the Mauritian context into account, considering sectors where advantages could be gained in the light of the country's strengths and development goals. Dabee (2000:4) notes that even though GATS allows some leeway for sectors to liberalise, 'the selection of some important sectors may be influenced by the larger or more advanced member countries at the level of the WTO'. He argues that developed country interests were particularly dominant in agreements on basic telecommunications and financial services.

Concerns about services liberalisation under GATS have led to a growing debate on the costs and benefits of services liberalisation at the regional versus multilateral level (Fink and Jansen 2007; Mattoo and Fink 2002; Stephenson, 2002). In discussing this issue, cognisance needs to be taken of Article V of GATS governing the services provisions of RTAs. Article V appears to require economic integration

agreements in services to be 'more liberalizing' than GATS (Stephenson 2002:17).¹² In addition, Fink and Jansen (2007) have argued that there are important ways in which services RTAs have less potential for discrimination than goods RTAs. For example, they argue that GATS Article V.6 generally ties services RTAs to more liberal rules of origin than goods RTAs. Article V.6 provides that a service supplier should 'be entitled to treatment granted under such agreement, provided that it engages in *substantive business operations* in the territory of the parties to such agreement' (cited in Fink and Jansen 2007:15; emphasis added). This suggests that service suppliers operating in an RTA member country need not be locally owned or domestically controlled in order to obtain RTA preferences.

It is unclear whether any meaningful equivalent to the 1979 GATT Enabling Clause applies to services provisions of RTAs among developing countries. Article V.3(b) does allow RTAs among developing countries to restrict the granting of preferences to providers of services 'owned or controlled by persons of the parties' (Fink and Jansen, 2007:15). However, Fink and Jansen report that little use of this stricter origin rule has been made by developing country services RTAs. This is an area requiring further research.

Mattoo and Fink (2002) consider the conditions under which countries may benefit more from regional as opposed to multilateral services cooperation. Their economic analysis of preferences in the services context takes the orthodox view that, while there is less chance of trade diversion in the services case than under preferential goods liberalisation (since tariffs are not common), and while there are possible benefits from greater competition, economies of scale and knowledge spillovers, non-preferential services liberalisation would be better. They argue that more research is needed to investigate the potential impact of regional services liberalisation on agglomeration forces versus tendencies for the spreading-out of service firms.

Mattoo and Fink (2002) do identify two aspects where regional services liberalisation may be more beneficial. The first is that, depending on the provisions of the agreement, more efficient bargaining may be possible on the part of a services RTA. Secondly, regulatory cooperation may be more feasible or desirable in a regional

¹² Regional agreements should have 'substantial sectoral coverage' (this applies to number of sectors, amount of trade *and* modes of supply) and provide for the 'absence or elimination of substantially all discrimination' within a reasonable period of time (Stephenson 2002:17).

context, which may lead to economies of scale. It is argued that a sector-by-sector approach would be most beneficial in order to identify key service sectors (such as transport services) for deeper regional integration. Sequencing of preferential and non-preferential services liberalisation could be important, however, since location-specific sunk costs may mean that a higher-cost supplier becomes entrenched (Fink and Jansen 2007:7). However, learning-by-doing may offset this problem, and some costs may be justified by regulatory or regional development objectives.

If regional services liberalisation has some advantages, is there a case for developing countries to pursue such liberalisation in South-South as opposed to North-South services RTAs? It is too early for a detailed assessment of the impact of most services RTAs, and the necessary data is in any case unavailable in many instances. However, Stephenson (2002) explores the achievements of Latin American RTAs that contain services provisions, noting the proliferation of agreements between developing countries allegedly given impetus by Mexico's participation in NAFTA. She finds that many such RTAs have opted for a 'negative list' approach to regional services liberalisation (where restrictions affecting all services sectors are listed) as opposed to the 'positive list' approach of GATS (where only information on commitments made in specific sectors is listed). This, it is argued, makes the approach to services liberalisation in the RTAs more transparent and stable (Stephenson 2002:6-9). The participants in such developing country RTAs are also able to work towards deeper integration in areas in which a regional approach may be particularly beneficial, such as construction and engineering, professional services and regulatory harmonisation.

Part of the reason for RTAs going further than GATS in terms of services provisions is doubtless due to the need for such groupings to comply with Article V of GATS. However, developing country RTAs in Latin America and the Caribbean do not appear to have made use of special and differential treatment clauses such as Article V.3(b), and seem to be more comfortable with deeper commitments at the regional level while remaining circumspect on services liberalisation at the multilateral level. A sector-by-sector approach is once again indicated, with further analysis needed of which services are more suitably supplied domestically, regionally or internationally.

In southern and eastern Africa, the debate about regional versus multilateral services liberalisation, as well as that about North-South versus South-South regional contexts has been dominated by issues surrounding the Economic Partnership Agreement (EPA) negotiations with the European Union (Kwa 2008; TWN 2008). The implications of this for regional production sharing and trade are considered further in the concluding section below.

6. Conclusions and implications for regional integration policy in Eastern and Southern Africa

The analysis in this chapter suggests that production sharing and fragmented trade could give renewed impetus to regional integration as a vehicle for development through industrialisation. If so, regional integration policy needs to be directed both with respect to services trade liberalisation and the identification and promotion of regional production networks.

With respect to services liberalisation, SADC's options range from restricting services liberalisation offers to the multilateral setting to a full range of negotiations – multilateral, intra-SADC, SADC-EPA and other bilateral negotiations. As noted in Section 5, however, caution is urged due to the implications of haste and/or poor sequencing of liberalisation and deregulation. Properly informed research at the sectoral level, and debate focused on development theory and experience elsewhere, are needed. The discussion in Section 4 suggests that a careful assessment is necessary of which services should be supplied domestically or regionally, and which should be sourced from outside Southern Africa.

One particular question that arises is whether services liberalisation under the EPAs could assist in harnessing the services sector to promote production sharing in eastern and Southern Africa. Jansen (2006:10) argues that whether the region should liberalise services in the EPAs largely depends on the nature of the particular services sector and the competitiveness of that sector in the global context. She notes that the EU is a major trading partner in commercial services for eastern and Southern Africa in both export and import terms, and argues that if the EU is more competitive than other suppliers in a given sector, then the risk of opening up to the EU in a regional context rather than, or prior to, liberalising multilaterally will be lower (Jansen 2006:7-11). However, her sectoral analysis finds that not all sectors are

suitable for liberalisation under the EPAs, given their different characteristics.¹³ In addition, the mode of supply is important, with liberalisation under Mode 3 (commercial presence), for example, bringing with it less likelihood of instability than Mode 1 (cross-border supply) liberalisation.¹⁴

The first significant problem highlighted by this analysis is that if mode and sector are of major importance in the costs and risks associated with regional versus multilateral liberalisation, then services liberalisation in only selected sectors and/or modes of supply in the EPAs may not comply with Article V of the GATS in terms of having sufficient sectoral coverage (see Footnote 12). Secondly, a North-South RTA context will not allow the countries of the region to take advantage of any special and differential treatment provisions of Article V, so that obligations are likely to go further than those required under GATS. Additional concerns are that services liberalisation in the EPAs would follow a positive list approach, as in GATS (Jansen 2006:3), in contrast to the approach adopted in many developing country RTAs. Further, uncertainty surrounds the status and implications of the EU's rules of origin in the context of the opening of services in the EPAs (TJM 2007).

Jansen's (2006) analysis does explore the possible advantages of regional services liberalisation *within* southern and eastern Africa in certain sectors and for particular modes of supply. The discussion, however, is largely conducted in terms of possible regulation and harmonisation benefits in sectors such as professional services and telecommunications. Little attention is paid to infant industry arguments and the potential for learning-by-doing, or to regional development objectives more generally. Further research on the services sector of the region in this regard at the sectoral level will be useful.¹⁵

The other shortcoming of the analysis is that its focus on services liberalisation in terms of supplier competitiveness and service sector characteristics does not engage with developing country concerns about the EPA negotiations that are of relevance to

¹³ For example, it is argued that telecommunications, transport and business services are more suitably liberalised multilaterally, while financial services, tourism and Mode 4 liberalisation could be fruitfully pursued in the EPAs.

¹⁴ See Jansen and Vennes (2006) for a more detailed discussion of this point in the context of financial services liberalisation.

¹⁵ The work of Kox and Nordas (2007) on how effective and carefully designed domestic regulation in services sectors can lower trade costs and improve competitiveness could be important in this context.

the inclusion of services in the negotiating agenda. A detailed discussion of the contested nature of the EPA negotiations is beyond the scope of this paper, but arguments that are important in the services context include that the EPAs are WTO-plus and, in contrast to their predecessors, are motivated less by development objectives and more by developed country commercial interests. As such, they are said to restrict developing country policy space (TJM 2007). The MFN clause in the EPAs is seen to interfere with SADC's regional integration agenda and with broader South-South RTA agendas, such as those with Brazil and India. The negotiations have fragmented the region into different country groups even within existing blocs like SADC. A common position on services and the Singapore issues within SADC itself have yet to be developed, and more time is needed for the region to develop negotiating, institutional and regulatory capacity (TJM 2007; TWN 2008).

Returning to the analysis of regional production networks, further empirical work is needed, building on the work of Petersson (2003), Nordas (2001), Nordas et al. (2000) and Visser (2001a,b), to identify regional production chains involving the countries of eastern and Southern Africa, and regional policies for their promotion. Such work could fruitfully draw on the lessons of studies such as Langhammer (2006) and Ruane and Görg (2001). In addition, further research is needed on the possible benefits of South-South partnerships with countries such as Brazil with respect to production networks and South-South FDI.

Any discussion relating to regional integration in eastern and Southern Africa would not be complete without reinforcing the need to address two key constraints which continue to hinder the region's trade and development agenda. The first is the complexity of rules of origin in the SADC FTA, together with associated problems resulting from overlapping membership of eastern and Southern African RTAs, and EU rules of origin in the Cotonou Agreement and the EPAs. Research by Brenton et al. (2005) finds that the SADC and EU rules of origin hinder the ability of RTAs in the region to facilitate development through trade. The analysis of Arndt (2001, 2004a) also suggests that such rules may hinder the potential benefits of regional production sharing. Other mechanisms, such as agreed-upon infant industry provisions and safeguard measures, should be used to achieve any necessary intra-regional protection objectives.

The second critical factor is the need to address the ongoing presence of significant non-tariff barriers to trade in the region and, in particular, prohibitive intra-regional transport costs (considered elsewhere in this volume by Mutambara). The prospects for benefiting from regional production sharing and fragmented trade will otherwise be seriously undermined.

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