United Nations TD/B/C.II/MEM.2/8

United Nations Conference on Trade and Development

Distr.: General
15 December 2010

Original: English

Trade and Development Board
Investment, Enterprise and Development Commission
Multi-year Expert Meeting on International Cooperation: South–South Cooperation and Regional Integration
Third session
Geneva, 23–25 February 2011
Item 3 of the provisional agenda
Using South–South linkages to build productive capacities in developing countries

Strengthening productive capacities: A South–South agenda

Note by the UNCTAD secretariat

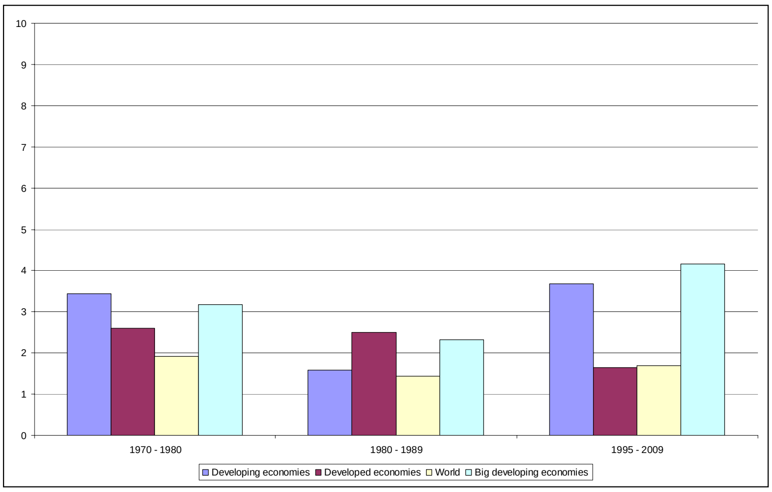
Executive summary

There is widespread agreement among economists and policymakers that a rapid and sustained increase in productivity is a sine qua non for rises in living standards. In surveying the experience of today's advanced economies (including those in East Asia), it is difficult to avoid the conclusion that a diversified industrial sector is the basis for strong productivity growth. A number of empirical regularities link growth to industrial development, particularly the subset of manufacturing activities. In general, these regularities confirm the importance of building productive capacities in reaching a high threshold level of income and gaining from closer integration into the international economy. The challenge for policymakers is, accordingly, to find which "productivist" policies work best to generate a virtuous circle linking capital accumulation, job creation, economic diversification, technological upgrading and higher incomes. Consensus has been elusive. In particular, the challenge of simultaneously building productive capacities while opening up to international market forces continues to provoke considerable debate and disagreement. These debates have taken on increased significance since the financial crisis of 2008, both because that crisis shattered some of the truths of recent policy wisdom and because the economic adjustments that it triggered will impact negatively on development prospects in the South. In light of these developments, this background note examines how increasing South–South cooperation might support efforts towards building productive capacities in developing countries, and in doing so, help narrow economic gaps across the global economy.

I. Decoupling and catching up: Development challenges after the crisis

1. Developing countries have, on average, been growing faster than developed countries for some time, with a noticeably stronger performance over the past decade; indeed, on a per capita basis, the difference in growth rates has been unprecedented (chart 1). As a result, developing countries' share in global output has risen sharply since 2000 (chart 2). Moreover, the impact of the economic crisis, which began in the United States housing market in 2007, has been generally less severe in the South than in the North, and the recovery has been stronger in many developing countries.

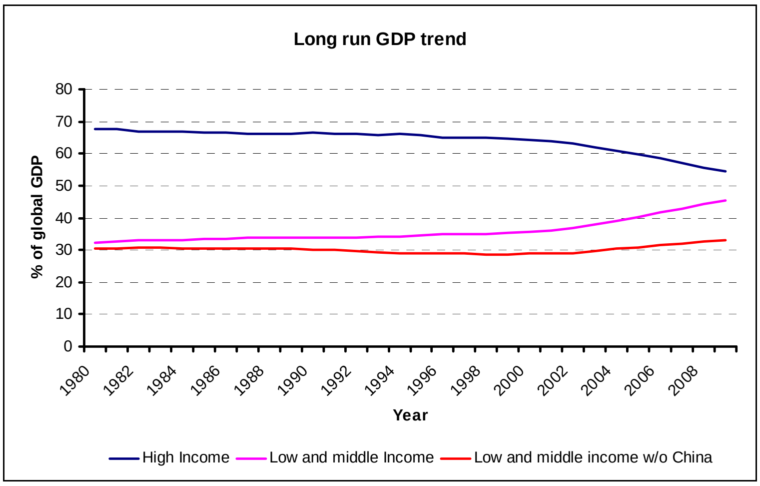
Chart 1
Average per capita growth rates: Developed and developing countries (percentages)



Source: Unit on Economic Cooperation and Integration among Developing Countries (ECIDC), based on UNCTADstat.

Note: "Big developing economies" represents the simple average of per capita growth rates of seven countries: Brazil, China, India, Indonesia, Nigeria, Pakistan and South Africa.

Chart 2
Distribution of global output



2. While some developing countries remain more vulnerable than others to contagion from cyclical downturns and shocks in advanced countries, the crisis has strengthened the view of a decoupling of growth in developing from developed countries. This has been attributed by some (IMF, 2008) to the adoption of better economic policies in line with fundamentals, and holds out the prospect of sustained growth in developing countries even if growth in advanced countries, as seems likely, remains sluggish, leading to a convergence of incomes worldwide. More optimistically still, recovery in developing countries might also allow developed countries to adjust more quickly and with lower welfare losses, thereby lifting all boats onto a new global growth trajectory.

3. Two closely related factors give support to this decoupling thesis:

(a) The emergence of strong and sustainable growth poles in the South;

(b) Closer South–South economic linkages, through rising trade, capital, technology and labour flows.

4. Unlike the periods of economic convergence in the 1970s and 1980s, when growth in large developing countries lagged behind that in developed economies, between 1996 and 2009 larger developing countries achieved a per capita growth rate higher than the developed country average, in the process helping to pull average growth rates in developing countries to historic highs (chart 1). Such growth poles can – if history is any guide – provide positive spillovers to other countries through new export markets and improved terms of trade (particularly for commodity exporters), as well as new sources of development finance and access to technologies.

5. This has also certainly been a period of rapidly growing South–South links. Trade flows have been leading this process. Between 1996 and 2009, South–South trade grew at an average of 12 per cent per year, 50 per cent faster than North–South trade. Such trade now accounts for around 20 per cent of global trade, and over half of developing-country trade (chart 3). South–South foreign direct investment (FDI) has also been growing rapidly, at perhaps 20 per cent per annum over this same period, albeit from a lower starting point, and now accounts for around 10 per cent of total FDI flows (table 1). Moreover, while high-income countries remain the main source of remittances for developing countries, migration between developing countries is now larger than from developing countries to OECD countries.

Chart 3
Evolution of South–South trade, 1995–2009

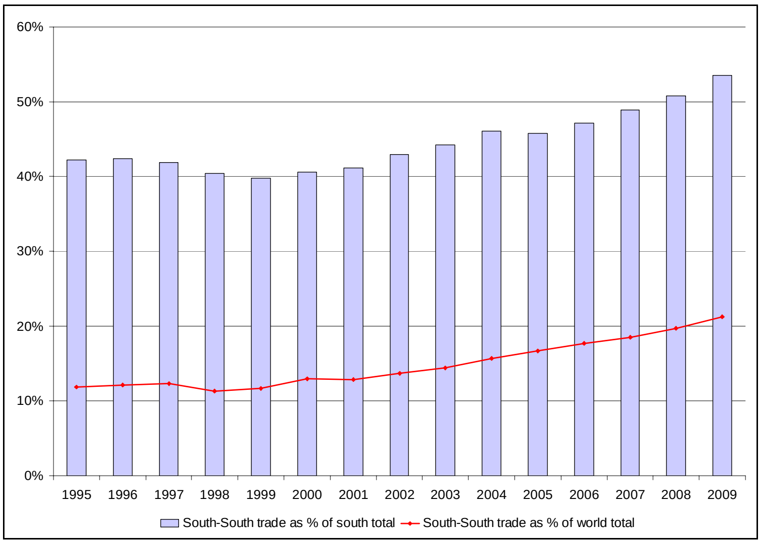


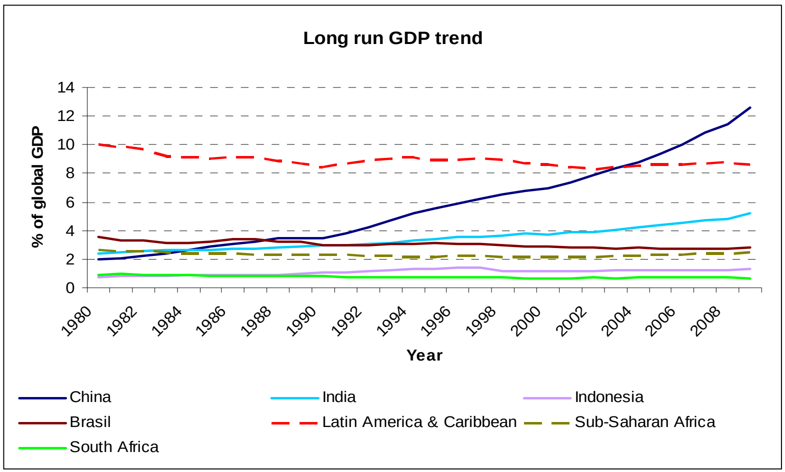
Table 1
Evolution of South–South FDI. 1990–2006

Year	World outward FDI (billions of dollars)	South–South FDI* (billions of dollars)	South–South FDI as percentage of world total	Growth rate South–South FDI
1990	241	12	5	-14
1991	198	9	5	-23
1992	203	16	8	81
1993	243	17	7	6
1994	287	25	9	41
1995	363	27	7	10
1996	396	35	9	29
1997	476	45	9	28
1998	682	29	4	-36
1999	1077	37	3	28
2000	1233	35	3	-6
2001	753	41	5	16
2002	537	30	6	-26
2003	566	39	7	29
2004	920	77	8	96
2005	893	88	10	15
2006	1411	145	10	64
2007	2267	180	8	25
2008	1928	187	10	4
2009	1100	149	14	-20

Note: * Calculation excludes the Cayman Islands, British Virgin Islands, and Hong Kong (China).

6. Still, a degree of caution is warranted when discussing whether these South–South links have become part of virtuous and sustainable catch-up growth paths across the developing world. In the first place, growth patterns have been uneven. Indeed, looking at trends over the past three decades, only China, and (more recently) India have seen a strong and sustained pick-up in growth and an increase in their share of global output (chart 4).

Chart 4
Different growth paths across the South

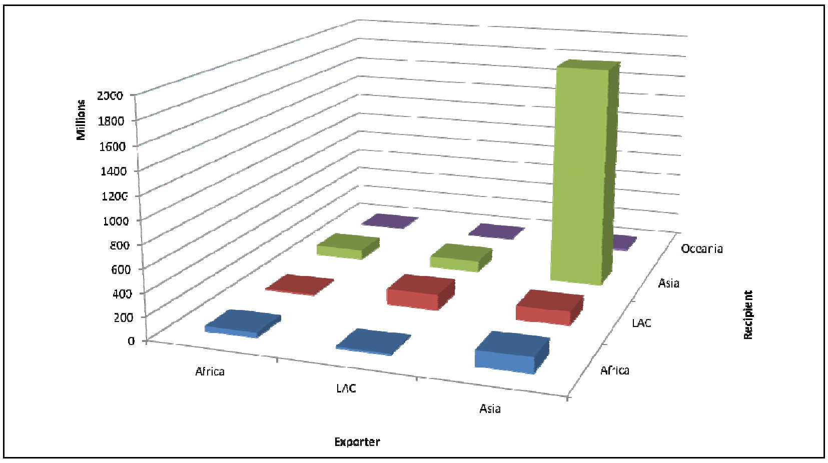


7. Furthermore, while it is true that, in the last decade, trend growth in non-Asian developing economies has become substantially higher than in advanced economies, the gap with respect to China and India remains wide. Even Brazil – the leading South American economy – grew, on a per capita basis, by under 2 per cent per year, more than 7 percentage points below China, and lower than its own trend growth in the 1960s and 1970s.

8. Another crucial difference between the two Asian countries and other growth poles in the developing world emerges from looking at their correlation with the economic performance of OECD countries. Whereas, in the last decade, the per capita growth rates of China and India have displayed a minimal correlation with the OECD countries (around 0.1 in both cases), growth in Latin America and sub-Saharan Africa remains strongly associated with the performance of the advanced economies, with correlation rates of 0.5 and 0.6 respectively. This suggests that growth still relies heavily on the markets of advanced economies, and raises questions about the chances of sustaining fast growth if the North enters a period of systemic slowdown.

9. The primacy of China and India is also reflected in the pattern of South–South links, which have been very heavily biased towards the Asian region. This is particularly true in the case of trade, where intra-Asian trade accounts for three quarters of total South–South trade (chart 5). Asia also dominates South–South FDI flows, although not as prominently.

Chart 5
South–South trade by region, 2009
(millions of dollars)



Source: ECIDC, based on UNCTADstat.

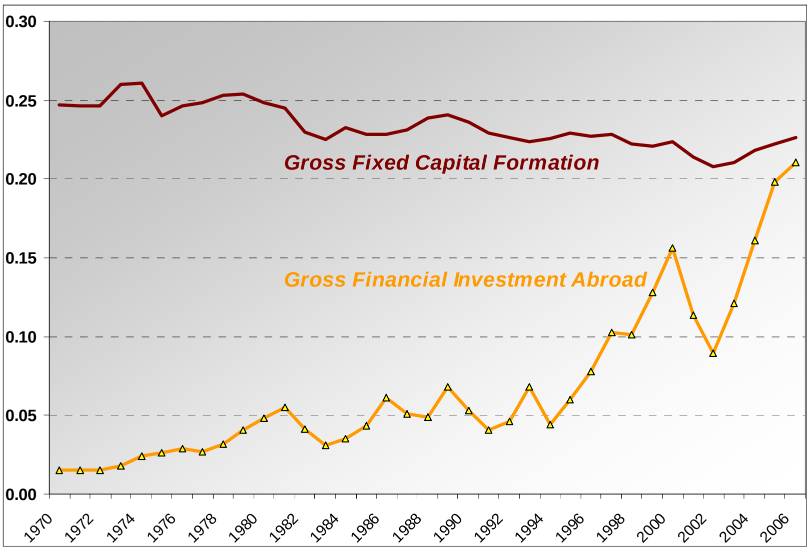
10. It is also important to note that the pattern of growing South–South links driven by trade and FDI flows has been nestled in a wider pattern of global integration driven more by very large cross-border financial flows. South–South capital flows have, by contrast, been particularly weak, even in Asia where capital outflows to advanced countries have dwarfed intraregional and other South–South flows (table 2). The links between financial liberalization, financial flows and economic development remain a contested area of discussion amongst economists. However, there is little evidence to suggest that the explosion of cross-border financial flows has translated into a faster pace of capital formation (chart 6), or that it has helped to accelerate the process of structural change. Indeed, financial openness has coincided with a process of structural regression in many developing countries.

Table 2
Portfolio investment assets, Asean and Asean+3, 2001–2005
(stocks in per cent of GDP)

	2001	*2002*	*2003*	*2004*	*2005*
ASEAN					
Portfolio investment	21.2	21.9	24.4	27.4	26.7
Equity	6.3	6.0	6.8	8.20	8.8
Intra-ASEAN	1.6	1.4	1.2	1.9	1.7
Extra-ASEAN	4.7	4.6	5.6	6.3	7.1
Debt	14.9	15.9	17.5	19.2	17.9
Intra-ASEAN	0.8	0.9	1.5	2.2	2.0
Extra-ASEAN	14.1	15.0	16.0	17.0	15.9
ASEAN+3					
Portfolio investment	22.4	24.2	27.3	29.0	29.2
Equity	4.2	3.9	4.6	5.6	6.1
Intra-ASEAN+3	0.2	0.3	0.3	0.4	0.4
Extra-ASEAN+3	3.9	3.7	4.3	5.2	5.6
Debt	18.3	20.3	22.6	23.4	23.1
Intra-ASEAN+3	0.5	0.4	0.4	0.5	0.5
Extra-ASEAN+3	17.8	19.9	22.2	22.9	22.6

Source: Trade and Development Report 2007 (please refer to table 5.3 on page 129 for further details).

Chart 6
A not-so-healthy global investment climate
(per cent of global GDP)



11. A final reason to be cautious about the decoupling story is the attribution of favourable trends to “better policy fundamentals”. Even among the larger developing countries, growth and development trajectories have differed over the past decade, and there have been differences in policy regime, particularly with respect to macroeconomic and sectoral policies. As a consequence, the impact of these larger growth poles on development prospects in other developing countries, through the provision of markets, resources and technologies, is likely to have varied significantly.

12. The processes of catching up and convergence are not as ubiquitous or as robust as suggested by a simple decoupling thesis. Rather, growing South–South ties and cooperation harbour strong potential, however this needs to be harnessed to a more active policy and cooperation agenda around building productive capacities if there are to be widespread gains across all developing countries.

13. In a similar vein, Rodrik (2009) has suggested that development strategy, which he identifies with concerted efforts to shift resources from low-productivity traditional sectors to high-productivity modern sectors, particularly those producing tradeable manufactured goods, will, after the crisis, need to adjust to weaker North–South ties, particularly in trade. In this context, he highlights the critical role of “productivist” policies in successful countries, including explicit industrial policies, undervalued currencies and financial repression. He concludes that the adoption of such policies will be even more important than in the past as countries look to boost the domestic demand for tradeable goods, but that their success depends on greater cooperation among economic interest groups, along with the availability of sufficient policy space. These two conditions are just as relevant to developing a South–South agenda, to the extent that this aims to build productivist strategies as part of efforts to forge new development paths in the post-crisis era.

II. Arthur Lewis revisited: Lessons for South–South cooperation

14. The discussion of South–South integration and cooperation is not new territory for economists. Writing at a time of heightened interest in South–South cooperation, Arthur Lewis, in his 1979 Nobel lecture, anticipated much of the recent discussion around decoupling and catch-up growth. In his lecture, Lewis asked whether the South could continue to grow at 6 per cent per annum if the North, as he expected it would, slowed down sharply. The critical link for Lewis was trade; sustained rapid growth would require strong export growth, but if demand was shrinking in Northern markets, could other developing countries fill the gap? Lewis suggested that South–South trade could fill the gap, both in the aggregate and for potential sectoral bottlenecks such as agriculture and capital goods.

15. However, Lewis recognized that much more was involved in strengthening South–South links than scaling up regional trade agreements. Rather, preferential trade arrangements, particularly among the larger developing countries, would have to be matched by a series of complementary measures to tie South–South trade to strong and self-sustaining catch-up growth in the South. This would include effective measures and financing mechanisms to deal with balance of payment problems, including those that might arise between the North and the South, as well as appropriate levels of finance for rising South–South flows. He also envisaged the need for compensatory financing mechanisms to help vulnerable countries and primary exporters who might find the shift to new markets in the South difficult in the short and medium term; along with new rules on transnational corporations, given their likely prominent role in expanding South–South manufacturing trade and the possible threat of a race to bottom that might accompany this trend. Finally, the strong domestic investment push needed to ensure self-sustaining growth would need access to long-term development finance, at least in the initial stages.

16. In many respects, Lewis's positions mirrored those being promoted at that time in UNCTAD, particularly in advancing a generalized system of preferences among developing countries, which was launched in 1976 with the aim of expanding and diversifying trade among developing countries and as a means of accelerating industrialization and strengthening their collective self-reliance, including by extending trade advantages for relatively less developed countries.

17. If developing countries are today facing another "Lewis moment", then it is important to understand whether a similarly comprehensive South–South agenda is also needed to promote catch-up and self-sustaining growth across the South. As was suggested in the previous section, conditions are, in some important respects, better than in the early 1980s, but many elements are still missing, and the uneven pattern of South–South links does not suggest an automatic sharing of the potential gains, raising the possibility of diverging trends among developing countries.

III. Economic diversification and productive integration

18. Productivity growth, economic diversification and income levels are strongly correlated across countries and over time. What turns these correlations into explanations of economic development continues to be debated. However, if history is any guide, building productive capacities in the industrial sector must be seen as a critical axis. A North–South dichotomy is unlikely to capture the range of challenges facing different developing countries looking to strengthen their productive capacities. In previous research, UNCTAD has distinguished between mature industrializes, rapid industrializes, enclave industrializes, premature deindustrializers and commodity-dependent exporters. This typology is not exhaustive; it excludes, in particular, those economies where strengthening productive capacities in the agricultural and services sectors is important. However, it serves as a useful reminder both of the key role of industrial development to long-term growth and of the likely diversity of experiences which will need to be incorporated within South–South agendas.

A. The spread of industrial development

19. The potential of building up the industrial sector derives, on the supply side, from a predisposition to scale economies, specialization, technological change and learning; and on the demand side, from favourable price and income elasticities.[1] Successive rounds of increasing productivity growth, rising demand and increasing returns to scale fuel a virtuous growth circle of expanding output, employment and consumption.

20. As the market grows, and as technological progress lowers the costs of coordination, new opportunities for product differentiation emerge, especially in specialized intermediate and capital goods sectors, but also through a growing variety of consumer and producer goods. This process, whereby firms also divest existing functions to new specialized firms, implies increased market transactions across more and more firms in the same sector. All this adds greatly to the linkage constellation behind successful growth dynamics.

21. The linkages created by a progressively sophisticated industrial division of labour are likely to spread beyond the national economy. Domestic firms that cross various

[1] The stylized facts, which give a premium to industrial development, are associated with the classical development literature, as exemplified in the research of Myrdal, Prebisch, Kaldor, Lewis, Hirschman and others.

thresholds in terms of size and technological know-how tend increasingly to trade abroad. Exporting, in turn, enlarges the size of the market and thus allows scale economies to be further exploited, while a growing outward orientation also exposes firms to new products and processes, and to new sources of competition. Industrial differentiation broadens the scope for intra-industry trade, particularly among countries with similar economic structures and technological capabilities. As a result, the same regions that dominate world industry also dominate world trade (table 3).

Table 3
Total trade, trade in manufactures and manufacturing value added, EU-15, NAFTA and East Asia 2000, 2005 and 2009

Share of total trade in world trade			
	1995	**2000**	**2009**
EU-15	40.4	35.8	32.6
NAFTA	16.5	19.0	12.9
East Asia	19.4	19.4	21.5
Total	76.3	74.2	67.0
Share of region's manufactured exports in world manufactured exports			
	1995	**2000**	**2009**
EU-15	41.8	37.6	36.7
NAFTA	17.0	20.5	12.5
East Asia	24.9	24.7	29.0
Total	83.7	82.8	78.2
Share of intraregional trade in manufactures in world trade in manufactures			
	1995	**2000**	**2009**
EU-15	24.9	22.4	20.3
NAFTA	8.1	11.4	6.3
East Asia	8.0	8.1	10.7
Total	41.0	42.0	37.3
Share of world manufacturing value added			
	1995 [a]	**2000**	**2009** [b]
EU15	26.2	26.1	28.6
NAFTA	28.4	31.8	22.3
East Asia [c]	28.9	26.3	25.5
Total	83.4	84.2	76.4

Source: ECIDC/UNCTAD based on UNCTADstat and WDI.

22. Manufacturing firms, as they grow, may also seek further advantages by establishing affiliates abroad. The resulting FDI flows are predominantly undertaken by large and technologically sophisticated firms seeking to enlarge rents from their specific assets, with some combination of cost differentials, large market size and technological sophistication determining location. Moreover, as more and more countries advance, there will likely be considerable FDI flows in the same sector, i.e. through intra-industry flows.

23. Some overseas production will involve the replication of entire plants abroad, but there can also be vertical disintegration of industries geographically through FDI, as individual activities are detached and relocated. The degree of fragmentation will vary from sector to sector, depending on the extent to which new technologies help reduce coordination costs, and on the linkage intensity of particular activities. The resulting

"international production networks" that emerge from this process will likely accelerate the cross-border movement of component parts and semi-finished products, which in many cases will take the form of intra-firm trade (UNCTAD document TD/B/COM.1/EM.18/2, part 2, chap. III).

24. Where neighbouring countries undergo a similar process of industrial take-off and diversification, cross-border linkages, at the sectoral and firm levels, can be expected to intensify. Productive integration through trade flows and production-sharing ultimately depends on the decisions of firms, not of governments; but national industrial policies can support this process, and coordination and harmonization of such policies can help make national industrial policies more effective.

25. Once external linkages reach a certain level of intensity, there will be pressure from producers, beginning at the regional level, to lower or remove the various barriers to intraregional trade and investment, including bureaucratic red tape, conflicting legal restrictions and administrative procedures, and there will be demands for better transport and communications infrastructure. These various demands are likely to be accompanied by the creation of institutions for closer cooperation.[2]

(a) Is industry still the key to growth and development; what is the role of modern services?

(b) Do South–South production networks offer a new path to sustainable growth?

(c) Do South–South ties better support productive jobs and rising wages?

B. South–South cooperation and industrial development

26. Formal cooperation is not a precondition for de facto integration, but larger and more inclusive gains will likely require a dynamic interaction between the two. At first, such cooperation will tend to focus on technical issues (trade barriers, standards etc.), but as production and trade systems become more integrated among neighbouring countries, the need for coordination and collaboration will grow. Historically, South–South cooperation has evolved furthest at the regional level.

27. Access to a larger market, as a means to achieving scale economies and diversifying production, has been a long-standing rationale for regional arrangements among developing countries, potentially avoiding some of the dangers of excessive protection that might accompany initial attempts to build productive capacities through import substitution strategies. In Latin America, where several countries embarked on industrial development during the inter-war period, regional integration has long been seen as providing the necessary elements for industrial upgrading, since new, more complex industrial structures necessitated economies of scale through the provision of a larger market. Moreover, there was a growing awareness that without such industrial upgrading, the gap vis-à-vis the more advanced industrial countries would keep widening. From this perspective, dynamic links between investment, exports and productivity growth underpinned the call for closer South–South ties.

28. A good deal of subsequent research confirms that what a country exports matters to long-term growth prospects, with successful countries using strategic trade and industrial policies to move into tradeable goods sectors that are more technology- and skill-intensive

[2] Intra-industry trade in Western Europe was already important in the 1950s, but the drive to keep reducing transaction costs by removing administrative and other obstacles often came from the enterprise sector. This was the case with the 1992 Single Market Programme.

and have the ability to generate technological and other spillovers to the rest of the economy and to neighbouring countries. However, the spread of industrial activity to neighbouring economies is not an automatic process; the varying volume of intraregional trade among different developing regional blocs gives an indication of the uneven process of industrial development, even where formal regional arrangements have been pursued (table 3).

29. UNCTAD's *Trade and Development Report 2007* suggests that South–South trade is biased towards manufacturing goods, including relatively more sophisticated products, holding out the possibility of greater learning effects and technology spillovers linked to such trade. In Latin American countries, regional markets are the leading destinations for their manufactured exports, especially for skill- and technology-intensive manufactures; in MERCOSUR, 50 per cent of the exports of high- and medium-skill and technology-intensive manufactures go to Latin American countries, although total exports to Latin America represent only 29 per cent of total MERCOSUR exports. Even in Brazil and Chile, for which the Latin American market is less important (in Brazil owing to its size, and in Chile because of its specialization in primary goods), almost 45 per cent of this category (i.e. the higher end of the technology- and skill-intensive manufactured exports) goes to the regional market.

30. Regarding Africa, while manufactured exports from COMESA, for example, represent only a small fraction of its total exports, it is nevertheless notable that manufactures account for more than 40 per cent of exports within COMESA and almost 50 per cent of exports to other African countries; half of these are high- and medium-technology-intensive and skill-intensive. The share of manufactures in intraregional exports is particularly high within SADC and with other countries in Africa, although the overall level is still very low.

31. The trade pattern of the East and South-East Asian region contains a very high share of intraregional trade in manufactures and reflects the way its production structure is organized. It imports high- and medium-technology-intensive goods, including capital goods, mainly from developed countries, electronic parts and components mainly from within the region, and primary commodities mainly from other developing regions. It exports a large proportion of labour-intensive manufactures and final electronic goods to developed countries, while high- and medium-technology-intensive goods and electronic parts and components are traded largely within the region.

32. While such evidence does suggest that South–South trade can generate shared gains for developing countries, it is not yet clear that such gains have been turned into longer-term structural transformation. Klinger (2009) has suggested that the picture of relative South–South trade sophistication is ephemeral and begins to weaken as countries move up the industrial ladder. Others, such as Shefaeddin (2008), have suggested that it is still less an integral part of an alternative development strategy and more a "defensive" response to the risks of relying too heavily on Northern markets, and a means of improving bargaining positions in multilateral or bilateral negotiations. Moreover, the distribution of the gains among the members of a South–South economic bloc is still likely to be quite unevenly spread.

33. One telling indicator of the distribution of gains is the structure of trade surpluses and deficits. Asymmetry between stronger and weaker partners can be exacerbated by the fact that the trade surpluses in the larger, more developed members usually account for a small proportion of their GDP, while the deficits in the smaller, less developed members often represent a significant proportion of their GDP. These asymmetries are due largely to structural factors, but economic policies and differing financial and institutional capacities among the members of a regional bloc could also accentuate existing asymmetries within the bloc.

34. In regional cooperation initiatives among developing countries, addressing disequilibria and inequalities has so far received relatively little attention. However, there are examples from Africa and Latin America of an awareness of the need to find a collective approach to these issues. MERCOSUR has established a Structural Convergence Fund (FOCEM) which addresses the problem of economic asymmetries within the common market, and SACU contains provisions to encourage the development of the less advanced members and the diversification of their economies through a common revenue fund.

35. There is considerable scope for developing and transition economies to benefit from the advantages of geographical and cultural proximity when seeking to develop their industries and upgrade their production. For this to be successful, members of the regional bloc need to cooperate in certain policy areas that may include agreeing to the full liberalization of intraregional trade, and, in customs unions, establishing a common external tariff. However, a regional dynamic will rarely be triggered by trade liberalization alone. Like the catch-up process in a single country, a common effort to reduce the gap with more advanced economies is more likely to succeed when measures related to trade and finance are complemented by other measures. For regional integration to be viable in the long run, some common regional policies and institutions may need to be developed to prevent greater income divergence among and within member States as a result of integration, which might trigger defensive measures on the part of the disadvantaged members and weaken the integration process.

36. An alternative approach would consider regional integration and other South–South ties among developing countries as providing a space for a development strategy based on industrialization. This has greater chances of succeeding than isolated national strategies, especially for countries with small domestic markets and limited technological capacities. This might require giving up some sovereignty in national policymaking, but at the same time, members may find their policy space enlarged through cooperation initiatives in areas where enlarged markets and shared resources can help promote investment and structural change. Allowing the relatively free movement of goods would not be enough to assure the sustainability of that framework. Proactive regional economic policies and other forms of South–South cooperation should also be developed that aim at fostering structural change, taking advantage of potential complementarities and specialization among the member countries and increasing the productive capacities of the less developed members.

C. Can South–South ties help commodity exporters to diversify?

37. The need to build productive capacities should not be exclusively identified with industrial development. Indeed, in many developing countries, raising productivity in agriculture is just as, if not more, important. South–South cooperation can play a critical role in this respect.

38. It should be recognized, however, that there are limits to the developmental effects that can be obtained from closer integration among developing countries, depending on the stage of development of the members of the group. Those countries and regions that have not yet developed a sizeable capital goods sector have still to earn the necessary foreign exchange to enable them to import capital and intermediate goods for which they rely on the industrialized countries or the industrially more advanced developing countries. Similarly, developing countries whose exports are highly concentrated in a small number of primary commodities will generally find limited markets in their own region and in other developing countries. For both reasons, developing countries that are still dependent on primary production or are at an early stage of industrial development can benefit less from regional integration with partners at similar stages of development than those that have already achieved a more diversified production structure. Even so, for countries looking to

diversify and upgrade their advantages in the primary sector, there are some potential benefits from closer South–South ties that need to be considered.

39. Using commodity exports to generate long-term economic growth and reduce poverty is a long-standing development challenge. According to many assessments, the "resource curse" is a binding constraint on development prospects in many poor countries (Sachs and Warner, 1995). On the other hand, other studies suggest that natural resources can become a real development asset when rents are effectively managed and are coupled with investments in skills and technology (Lederman and Maloney, 2007; and UNCTAD document TD/B/C.I/MEM.2/3).

40. Development gains have been maximized through the promotion of backward and forward linkages between oil and mining sectors with the rest of the economy. These linkages enhance the use of local inputs (procurement of goods and services) in the supply chain, which, in turn, generates positive impacts on local capabilities and the domestic economy. However, in several countries, the potential benefits from this sector have been limited by internal constraints, such as a weak policy framework, infrastructural and human capital deficits, and other structural problems. Similarly, development gains have been constrained in the agricultural sector because of supply-side constraints, in particular low productivity, paucity of finance, inadequate trade-related infrastructure, and a lack of technological innovation. Together, these constraints reduce opportunities for vertical diversification, including value addition. However, research by Kaplinsky (2010) suggests that building linkages in the extractive sector could be accelerated and deepened depending on sector-specific factors, ownership structure, adequate infrastructure, links to national systems of innovation, skills spillovers, regional capabilities, and the right policy environment.

41. Diversification of markets and products, or expanding trade, to new dynamic markets of the South as well as within developing regions also has the potential to enhance development gains, although this can be fraught with challenges. For example, vertical diversification would allow producing countries to add more value to their exports, and thus retain more value or income in the local economy. However, this requires (a) enhanced access to credit; (b) improved capacity to meet standards and technical requirements such as production and processing systems (see the WTO sanitary and phytosanitary (SPS) and technical barriers to trade (TBT) agreements), as well as other private standards or market requirements; (c) addressing infrastructural bottlenecks; and (d) removing tariff and non-tariff barriers, e.g. customs and other administrative procedures.

42. Diversifying horizontally into non-traditional commodities and local livelihood products, and vertically up the value chain, can help to reduce or eliminate the economic vulnerability derived from dependence on a few primary commodity exports. However, diversification requires significant investments, skills upgrading, and, for new products, the need to compete against already established players (see UNCTAD document TD/B/COM.1/EM.18/2). Linkages and diversification offer opportunities for unlocking development gains in the commodities sector, but this is subject to the existence of an enabling policy environment that promotes (a) human resource development through training, education and R&D; (b) technological innovation to create more competitive suppliers; and (c) improved infrastructure to overcome supply constraints.

D. Can South–South cooperation help break the middle income trap?

43. The structural transformation at the heart of economic development involves developing countries progressively changing their production structure, substituting low valued-added goods with more sophisticated products. A low-income country usually relies heavily on extractive resources, subsistence agriculture, monoculture exports and foreign

aid. Economic take-off starts with the building of productive capacities in manufacturing firms that perform simple assembly or processing of light industry products for export (e.g. garments, footwear and foodstuffs).

44. In these preliminary stages, growth is fostered by innovations inside the frontier, with developing countries undertaking the production of goods already produced elsewhere and diversifying their production and export structure. The gaps and constraints that must be addressed to launch a more self-sustaining growth process around economic diversification remain a challenge for many poorer countries. Access to new markets may provide the single biggest advantage to these countries from increased South–South cooperation. However, access to long-term investment finance and sharing policy experiences could add significantly to the South–South agenda.

45. To sustain the development process, diversification is not enough. A country must be able to progressively upgrade its human capital, raise internal value added by producing and exporting high quality manufactured products, and challenging more advanced competitors. Eventually, capabilities to develop and patent new products and processes must be acquired.

46. Thus, as countries develop, three important changes may be observed. Firstly, production diversification slows down and then is even reversed as income per capita reaches a certain high threshold (deindustrialization), and countries become more specialized in service activities. Secondly, investment becomes less important while innovation accelerates. Thirdly, the education and training system shifts from a focus on developing skills to adopt and adjust technology to one that prepares and enables workers to develop new processes and products.

47. However, these changes have not occurred in many middle-income developing countries. Climbing up the ladders and moving from inside-the-frontier to on-the-frontier innovations is not an automatic process. A large number of countries that have successfully overcome the subsistence phase and triggered economic growth have later failed to upgrade human capital. A majority of Latin American countries, for example, remain middle-income, even though they had achieved relatively high income as early as the late nineteenth century; and growth performance has differed significantly in depth and speed even among groups of countries that are considered "successful". Ohno (2009) has labelled this phenomenon the "middle-income trap".

48. The case of East Asia is particularly interesting – the region contains countries that have avoided the trap, and it has successfully used strong regional ties to support growth in neighbouring countries at different levels of development. However, the recent crisis has revealed the vulnerability of some countries in the region to trade shocks.

49. The strong growth noted earlier in the volume of intraregional trade in East Asia, largely through intra-industry trade in intermediate goods combined with intraregional FDI flows, represents a key feature of the successful East Asian experience. In this region, vertical integration has fostered the emergence of two kinds of regional production networks which operate mainly in the electric and electronics industries and the clothing sector – large TNCs that produce a standardized set of goods in several locations, and groups of SMEs that are located in different countries and are linked through international subcontracting to a lead coordinating firm (UNCTAD *Trade and Development Report 2007*).

50. In this context, however, many East and South-East Asian countries have become heavily dependent on exports of parts and components, most recently to China, increasing the risk of their exposure to demand shocks not only from final goods markets in advanced countries but also from increased competition from suppliers elsewhere in the region.

51. In particular, while the second tier of newly industrializing economies (NIEs) has reached the level of industrial exports achieved by the first tier in the late 1970s, it has not established the diverse manufacturing base that those countries achieved (with their emerging capital goods sectors, strong local supplier networks, and levels of skills and R&D). Perhaps of particular concern, these countries lack the medium-technology exports that were an important stage in the upgrading of the first-tier NIEs. The resulting "footloose" nature of the existing activities means that locational advantages can be easily won or lost on account of small changes or the emergence of alternative locations competing to attract TNCs.

52. China's role in the region is likely to become increasingly important after the crisis, particularly if, as seems likely, it shifts to a greater reliance on domestic sources of growth. This could reduce the number of suppliers of parts and components from the region even if China continues to grow through expanding domestic consumption. Reducing the region's dependence on Northern markets will likely require a shift from more vertical specialization and network trade to product-based horizontal specialization and intraregional trade in final products.

53. Market forces alone are unlikely to lead to the required structural transformation in these countries. There is, therefore, a need to begin regional discussions to establish a renewed industrial collaboration framework, including better harmonization of incentives on FDI, able to dovetail the structure of production to the pattern of domestic and regional demand and to foster a narrowing of gaps in productive capacities and incomes across the region. In order to overcome the trap and develop full capability of innovations, a developing country needs to implement the appropriate industrial policie,s which generally change along the process of development. While liberalization and trade integration can facilitate the attraction of capital and foster the diffusion of basic manufacturing firms, well-targeted policy action for upgrading industrial human resources and fostering the undertaking of more productive activities is necessary to deal with the externalities and coordination problems that characterize the later stages of the development process.

54. The WTO rules and the proliferation of free trade agreements (FTAs), however, have narrowed the policy space for latecomer countries, making it increasingly difficult to improve skill and technology and break the glass ceiling towards more advanced stages of development (UNCTAD *Trade and Development Report 2007*). Agreements among developing countries at relatively similar levels of development (South–South agreements) are different, insofar they seek to establish economic and political areas that would maintain or increase the policy options of their participants vis-à-vis the rest of the world. In this respect, increasing South–South cooperation may represent a potential way out from the middle-income trap for those countries that are still struggling to expand their supply capabilities and upgrade their industrial structure, by connecting to emerging growth poles in the South.

E. Policy space, productive capacities and South–South cooperation

55. Conventional economic thinking is ambivalent about closer South–South cooperation, seeing it as a likely source of resource misallocation, and a possible cause of welfare losses, increased rent-seeking and diminished technology transfer. The trade diversion logic underlying this conclusion rests, however, on an idealized and largely static view of markets, one that ignores a series of potential dynamic benefits linked to building and strengthening productive capacities in developing countries.

56. In recent years, regional and bilateral FTAs and preferential trade agreements have proliferated. However, even where these have been among developing countries, there have been few initiatives to strengthen proactive national policies that focus on creating

conditions favourable to capital formation, industrialization and structural change compared to initiatives for pushing trade and investment liberalization further than has been achieved at the multilateral level. In designing more effective cooperation agendas, it is important to adopt an integrated approach to the challenge of building productive capacities. Strategic trade and industrial policies, pro-investment macroeconomic policies, and financial measures and labour market policies must be used effectively and in the same direction. An integrated approach to breaking these constraints was the approach adopted in the early discussion on the Global System of Trade Preferences, which aimed to expand and diversify trade among developing countries by combining measures to cut trade barriers with complementary efforts to accelerate industrialization.

57. The development literature has identified (a) various constraints and gaps that can disrupt cumulative growth dynamics; and (b) where national development strategies might usefully be complemented through closer cooperation among developing countries. At the simplest level, this would include lowering technical and bureaucratic barriers to trade, ensuring the dissemination of a critical amount of information on trading possibilities, and institutional support for marketing exports. Cooperation on a variety of trade-related services such as insurance, export credits and trade facilitation could also come with closer South–South ties.

58. Harmonizing rules and laws on a regional basis and pooling resources are essential to ensure effective management in light of local needs and conditions. The provision of physical infrastructure, particularly in the form of transport and communication networks, is likely to be, in the longer run, as important if not more important than the reduction of tariff barriers and formal quantitative restrictions. Energy supply and management remains a binding constraint on the industrialization process in many developing countries, and effective cooperation in this area can help create productive capacities that expand their trade and growth potential. While in many respects the European experience may not be an appropriate model for regional cooperation among developing countries, which has to be conceived under very different historical, economic and political circumstances, it does suggest that in order to meet common challenges, such as accelerating diversification into dynamic sectors, upgrading the industrial structure and raising agricultural productivity, pooling regional resources might be a sensible way forward.

59. Other constraints on the growth process, such as those associated with technological development, where most developing countries rely heavily on accessing technology from abroad and absorbing it within local production systems, also need to be addressed from a South–South perspective. Even among developing countries technological skills and capacities are considerable, and while opportunities for collaboration are present, this could also be a potential source of further divergence.

60. National innovation systems may be devised with an explicitly regional or South–South dimension, involving collaborative research, training schemes and information-gathering, and may extend to complex institutional issues such as those relating to the design of intellectual property regimes.

61. Closing technological gaps through South–South FDI is seen as an important component of the expanding South–South agenda. Not only is there a belief that Southern TNCs might find it easier to operate in the business environment of other developing countries, but also that ownership arrangements based around stronger state or family ties might encourage greater spillovers of technology and other related skills. However, the evidence on whether TNCs from developing countries are a better source of spillovers than North–South FDI is largely untested and is an area in need of greater research.

62. Regional coordination and monitoring might better support the kind of policy space needed to effectively manage FDI, particularly in those dynamic sectors where there is a

danger of overinvestment. Uncoordinated policies aimed at attracting FDI can result in a race to the bottom as governments cut regulations and offer generous tax incentives in a wasteful bidding war to attract TNCs, rather than striking a favourable balance between costs and benefits (UNCTAD *Trade and Development Report 2005,* chapter III, section F). Regional arrangements may be a sensible way to manage some of these issues by forging consensus and establishing a common bargaining position on areas such as the harmonization of corporate codes, contract enforcement, tax incentives and avoidance, and transfer pricing.

63. Closer financial cooperation among developing countries could also support the industrialization process, in particular when access to international capital markets is costly, unreliable or non-existent. Regional institutions may be better placed to respond to regional needs and demands, and may also potentially be more effective (a) at providing regional public goods, especially those requiring large initial investments and regional coordination mechanisms, such as cross-border infrastructure supporting the development of regional capital markets; (b) at harmonizing their regulatory systems; and (c) at coordinating and helping to finance regional efforts at technological innovation. Scaling up these kinds of initiatives will be key to a more integrated South–South agenda.

64. Experience from regional and subregional development banks suggests that they can allow a far greater voice to developing-country borrowers, and also a greater sense of ownership and control. This is particularly the case for purely South–South institutions such as the Corporación Andina de Fomento, where countries are both clients and shareholders. Regional and subregional development banks are also more sensitive to the dangers of excessive conditionality and can allow disbursements of resources in a far more timely and flexible manner. Regional or subregional development banks are particularly valuable for small and medium-sized countries that are unable to carry much influence in global institutions and have very limited power to negotiate with large global institutions. Their voice can be far better heard and their needs better met by regional or subregional development banks. Furthermore, competition between two or more kinds of organizations, e.g. subregional, regional and global, for the provision of development bank services seems to be the best modality, as it provides small and medium-sized countries with alternatives to finance development (Ocampo, 2006).

65. Regional institutions may, finally, better share the experience of institutional development. Indeed, regional development banks' ability to transmit and use region-specific knowledge can make them particularly helpful to countries designing policies most appropriate to their economic needs and political constraints. However, knowledge on extra-regional experiences can be more difficult to acquire than from a global institution.

66. Financial and monetary cooperation among developing countries has received particular attention since the 1990s, partly because the development prospects of many countries have been shaped more by the globalization of finance than by global trade expansion. Financial crises in emerging market economies have illustrated the risks stemming from the volatility of private international capital flows, especially speculative short-term flows, and also the detrimental effects that the vagaries of international financial markets can have on international trade and sustained growth. They have also brought to light the lack of an effective international regulatory framework to deal with those risks. Moreover, dissatisfaction among governments grew, because conditionality went beyond what could be justified by the need to safeguard the resources of the IMF, thereby unduly violating the sovereignty of the borrowing countries, and also because it did not differentiate between country-specific circumstances.

67. This experience has given further impetus to regional financial arrangements as an alternative way of handling financial shocks and their aftermath. The growing volume of intraregional trade and investment flows, and the synchronization of business cycles within

regions, as well as the growing detachment of developing-country regional blocs from the more advanced regional blocs, has further encouraged this trend. Some observers believe that such arrangements point to new trends in regional cooperation in which regional financial institutions assume a much more active role in fashioning the integration process through macroeconomic coordination, exchange-rate management and monetary union (UNCTAD *Trade and Development Report* 2001 and 2007 editions, and *Least Developed Countries Report 2010*).

68. The institutional and political hindrances to moving forward remain considerable, and progress in implementing concrete measures has been tentative. Fully fledged regional systems of financial surveillance and policy coordination or exchange-rate coordination are yet to be elaborated. But with only limited reforms in the governance of global finance, building collective defence mechanisms against external shocks and strengthening macroeconomic coordination at the regional level remain firmly on the agenda of many developing countries. In all geographical regions, considerable attention has been focused on how to achieve exchange rate stability in order to prevent crises, and how to bolster trade and competitiveness, including through the use of regional currencies.

69. The fact that countries differ in terms of their creditworthiness and the types of flows they are likely to attract raises the possibility of different types of financial cooperation, coordination and surveillance emerging at the regional level. For countries with no or only limited access to commercial markets, official development assistance (ODA) remains key to financing development. There is an ongoing debate on how best to manage aid flows; there is a growing recognition that the current mix of bilateral and multilateral arrangements causes aid to be too politicized, too unpredictable, too conditional and too diffused to act as a catalyst for growth and domestic resource mobilization. A stronger South–South and regional dimension in coordinating and channelling aid flows may be one way to improve the effectiveness of the aid system.

70. Strengthened regional cooperation does not exclude other forms of international or South–South cooperation. Indeed, proximity matters for some areas of cooperation, but it may be irrelevant for others. An example of the need for South–South cooperation where proximity does not necessarily matter is for coordinated policies to attract FDI, especially in the primary sector, where countries in different regions but with similar natural resource endowments frequently “compete” for external capital. On the other hand, regional cooperation is more important for coordinating policies related to attracting FDI to the manufacturing or service sectors, where there is a greater likelihood for competing interests among countries in the same region to lead to a race to the bottom by offering too many incentives to potential foreign investors. Regional cooperation in this area would be easier if other elements of regional cooperation were already in place. Indeed, in some cases, it is precisely because certain institutional arrangements for cooperation and coordination already exist that regional cooperation in other areas becomes possible.

71. To the extent that global institutions have failed to sufficiently promote developing-country interests, regional financial arrangements are seen as offering the kind of sensitivity to and familiarity with local conditions that is needed to reconcile differing national needs and objectives with international opportunities and constraints. As the European experience shows, progressively more sophisticated regional monetary and financial arrangements can lead to greater stability in a region. In the absence of any major reform of the international financial system, they can also contribute to greater coherence in global economic governance. The fact that a number of developing countries have accumulated considerable foreign exchange reserves offers new options for monetary and financial cooperation among developing countries in general, and at the regional level in particular.

72. Finally, while market liberalization focuses on prices at the microeconomic level, stable trade and financial relations, combined with investment-friendly macroeconomic

conditions, require getting the macroeconomic prices (i.e. interest and exchange rates) right. In the absence of an appropriate multilateral framework, regional coordination and cooperation and developing an appropriate macroeconomic policy regime, including, in particular, monetary and exchange-rate management, could be a viable second-best solution.

Questions for experts

- Are South–South trade and investment flows more supportive of catch-up growth and structural transformation than North–South flows? Why?
- How useful is the BRICs grouping for understanding development prospects in the South? Is there a danger of excessive competition amongst countries in the South?
- Could closer South–South ties make developing economies more or less vulnerable to global shocks and imbalances?
- What combination of macroeconomic, trade and "productivist" policies would best support stronger South–South ties?
- What is the role for development banks, nationally, regionally and extra-regionally, in building productive capacities?
- Is policy coordination in support of productive integration possible beyond the regional level?
- How can South–South trade agreements be made more development-friendly?
- What kind of financial and monetary cooperation arrangements at the regional and South–South levels would best promote building productive capacities?
- Which trade-related services should be promoted at a South–South level?
- What are the obstacles to strengthening energy and transport infrastructures at regional and South–South levels?
- What has been the experience with upgrading in the primary sector through South–South value chains?
- Are there significant spillovers from South–South FDI flows?
- What kind of institutional arrangements are needed to help technology flow more freely across the South?