



# Trade Liberalisation and Regional Integration in SADC: Policy Synergies Assessed in an Industrial Organisation Framework

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# **Trade Liberalisation and Regional Integration in SADC: Policy Synergies Assessed in an Industrial Organisation Framework**

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## **Abstract**

Trade liberalisation has a significant impact on firm-market dynamics in a regional context. The purpose of this paper is to use an industrial organisation framework, focusing on the analytical units, the firm and the market, to assess the impact of trade liberalisation within the Southern African region, SADC. It is specifically the firm-level responses to various policies that will provide insight into changes in national industrial configurations, regional patterns of industrialisation and the potential for sustainable supply chain development in Southern Africa.

The purpose of intra-regional trade liberalisation is to facilitate trade within a regional economic space, and through enhanced trade opportunities to elicit firm-level decisions to expand productive capacity. Such expansion of productive capacity, through various modalities of investment, can have important implications for the development of markets and market processes, resulting in robust, sustainable regional development.

## **1. Introduction**

The impact of synergies (or the lack thereof) between economic policies in a regional context can be characterised in an industrial organisation framework. Within this industrial organisation framework, an extended Structure-Conduct-Performance (SCP) paradigm can be used to examine the responses of firms to various policy initiatives, and the consequent impact on market structures.

The underlying rationale for this approach can be summarised as follows:

'While other branches of economics show the typical firm as operating a single plant, making one kind of product and engaging in perfect competition, industrial economists work with a pretext that firms are often multi-plant, multinational oligopolists, who compete against each other by differentiating their products or by locking their customers into entire ranges of products ... and generally engaging in strategies which differ widely from the notion of perfect competition' (Stead, Curwen & Lawler 1996).

National policies and their explicit or implicit incentives, as well as the regional strategy for trade and industrialisation of the Southern African Development Community (SADC)Trade Protocol, play an important role in firms' decisions in the Southern African region. These national and regional policies may influence the transaction costs for firms involved in cross-border trade and other cross-border economic activities.

A FTA in itself provides an environment conducive to increased intra-regional trade and industrialisation; there are, however, aspects of market structure, and basic conditions in which firms operate that are addressed by national policy initiatives. The interface between national and regional policy is thus important from the firm's perspective as it makes decisions within national and regional markets. The geographic dimension of market definition is particularly important in a discussion on regional integration. Trade liberalisation changes this dimension of the market, as the boundaries between narrowly defined geographic markets become less defined.

## **2. Regional integration in SADC: an industrial organisation perspective**

Implementation of the SADC Trade Protocol began in September 2000 and will culminate in a free trade area (FTA) in 2008. This is expected to provide significant impetus to the process of economic integration and development in SADC. At present SADC attracts only one per cent of global foreign direct investment (FDI). With the implementation of the SADC Trade Protocol and the formation of a regional economy, SADC is expected to become a more attractive investment destination (SADC Summit 2000).

The dependency of SADC countries on the Southern African Customs Union (SACU) market for their regional exports is largely due to the lack of growth within the region. If there are links between openness and growth as proposed by the New Growth Theory, then the initiative to establish a FTA in Southern Africa is a positive step towards the expansion of the regional market. This will also promote industrial development in the region.

In this paper we illustrate the impact of tariff liberalisation on market structure within SADC; and in addition, the role of non-tariff barriers, Rules of Origin, as well as multilateral and bilateral trade agreements on market structures and firm-level decisions in SADC.

The dynamics between firms and within firms in the regional market are analysed in a market context. Specific driving forces for regional growth and integration are highlighted. We emphasise the need for non-traditional policies to stimulate and support these dynamic mechanisms that link firms and markets.

### **2.1 The impact of trade liberalisation on market structure and firm decisions**

The naïve form of the Structure-Conduct-Performance (SCP) paradigm postulates that market structure influences firm conduct and in turn firm performance. More nuanced versions of the SCP paradigm provide for feedback linkages, so that firm decisions and performance also impact on market structure.

In the context of this paper, tariffs are important determinants of a key feature of market structure; barriers to entry. With intra-regional tariff liberalisation, for example, market access conditions change and regional market structures will therefore change. Such changes in market access conditions may lead to changes in firm strategies as the geographic market that they supply changes.

Similarly, with extra-regional trade (tariff) liberalisation, as has been the case through the Africa Growth and Opportunity Act (AGOA), may include incentives prompting firm-level decisions which lead to changes in regional industrial development. As is indicated later in the paper, AGOA has prompted relocations of clothing firms from, for example, South Africa to Lesotho, thus changing the pattern of regional industrial development, specifically as it pertains to the regional clothing industry.

The links between trade and other policies (and the incentives implicit or explicit therein), firm decisions and market and industry developments in a regional context should be carefully analysed if policy initiatives are to have the desired impact on firm decisions and hence regional market developments.

### **2.1.1 Tariff liberalisation**

All SADC countries have been engaged in significant reform of their tariff regimes in recent years. These reforms have generally resulted in the lowering of most favoured nation (MFN) rates and the adoption of a cascading structure of tariffs, such that the lowest rates are applied to capital goods and raw materials, median rates are applied to intermediate goods, and the highest rates are applied to finished goods. Such tariff reductions are viewed as a necessary part of a broad restructuring process to make the region more competitive internationally. Tariff liberalisation first and foremost enhances market access, allowing entry of new firms, products and services into regional markets.

The implementation of the SADC Trade Protocol is expected to provide impetus to the process of economic integration and development in the SADC. Intra-regional trade liberalisation significantly alters the prevailing market access conditions and is bound to affect seller concentration and competition within the region in specific markets. The implication is that, from the perspective of a firm located in one country, access to

markets in other SADC countries becomes easier. A firm may therefore enter new markets, and the cumulate effect of such decisions by firms may alter the very definition of markets in the region.

### **2.1.2 Qualitative restrictions and quotas**

Intra-regional trade is in most cases free only for qualifying products. Moreover, various bilateral agreements within the region cover only a limited range of products and may have quota restrictions, further limiting the volume of preferential trade. South African agreements with Malawi, Mozambique and Zimbabwe, for example, all have quota and product restrictions (Imani Development 1997). The quantitative restrictions are significant, and are determined by a number of factors, including the absorptive capacity of SACU markets, and the industrial restructuring that may follow the entry of firms and products and services.

SACU's regional trade policies involve the application of tariff rates (*not ad valorem*) based on actual quantities of imports (R/kg). Zimbabwean trade officials have indicated that in addition SACU has been blocking clothing imports through specific restrictive requirements (e.g. boys shirts), although this has to some extent been relaxed in a more recent SACU offer (Shoniwa 2000). Member states agree that the elimination of tariffs alone will not be effective in increasing contestability of the regional markets. Non-tariff barriers pose significant challenges to increasing contestability, and these are in many cases much more difficult to address than tariff barriers.

A new SACU Agreement was concluded in October 2002 after eight years of negotiations. The new agreement is expected to be ratified by all member states by the end of 2004. It was agreed that with immediate effect any future bilateral trade negotiations would be conducted by SACU en bloc and not by individual SACU member states. Negotiations between SACU and the United States began in May 2003, and are expected to lead to the conclusion of a free trade agreement by the end of 2004. This means that SACU member states have to consider, at least in certain respects, common positions for the negotiations. Some focus on policy co-ordination is thus to be expected from this process.

In addition the new SACU Agreement provides for co-ordination of industrial policy by the member states, and also requires that all member states have a competition policy.

This may have a positive effect on both national and regional industrial development dynamics. The relationship between industrial and competition policy is important with regard to, for example, the promotion of small and medium enterprise (SME) development, and key questions as to the most effective channel of addressing such objectives need to be articulated between these two policy areas.

### **2.1.3 Rules of origin and market access**

The ability of countries in the region to exploit market access opportunities which may be obtained through economic integration arrangements are severely limited by supply and marketing constraints. Moreover, insufficient competitiveness in a number of export and production sectors still exists. The Rules of Origin, while encouraging import substitution at a regional level, specifically also exacerbate the problems associated with supply constraints within a region.

The Rules of Origin have been tailored to facilitate trade and to ensure that only products originating within the region have access to the preferential status provided by the FTA (*Namibian Economist* 4 August 2000). SACU countries, in particular, South Africa, have largely provided the motivation for the implementation of these rules. These requirements in essence provide a form of intra-regional import substitution, or trade diversion, but at the same time introduce a significant barrier to market access within the region, effectively drawing a distinction between SACU markets and non-SACU markets.

The current structure of the Rules of Origin is based on a two-stage transformation requirement. This transformation process is particularly relevant to the cotton-textile chain, for which there exists capability and capacity at all levels of production within SADC. The cotton production and processing sequence is as follows:

**Basic cotton→cotton yarn→fabric→clothing**

According to the SADC Rules of Origin, the transformation of fabric to clothing, and then yarn to fabric is required in the region. This means that the cotton yarn can be sourced elsewhere but has to be further processed locally.

"The two stage transformation will encourage agricultural production as well as agri-processing in Malawi" (Mandindi 2000). While it holds promise in supporting the

development of supply chains and intra-industry trade (IIT) within SADC, it presents considerable difficulties for most of the SADC members and many have inferred that, given the requirements, this will further limit market access to SACU. Many argue that these rules are much more stringent than what was in place before (Tyesi 2000).

It is commonly argued that if the Rules of Origin are fully implemented, not even SACU could supply the entire demand for inputs in the region. Although Zimbabwe and Mauritius are satisfied with a two-stage transformation process for cotton, they point out that raw materials such as silk, synthetics, and wool are not readily available in the SADC. Producers therefore need to import these inputs. Another important consideration is that existing sources for cotton products in the region are by no means competitive in terms of price and quality (Mandindi 2000).<sup>1</sup> This is further supported by the fact that SADC countries exporting cotton-based clothing to the United States under the current waiver from normal African Growth and Opportunity Act (AGOA) Rules of Origin (notably Lesotho, Kenya) source all their cotton textile requirements from outside the region.

Under the Cotonou Agreement<sup>2</sup> and Trade and Development Cooperation Agreement (TDCA – between South Africa and the EU), for example, the two-stage list rules for cotton clothing are “manufacture from yarn”, while the list rules for woven cotton fabrics are “manufacture from coir yarn/natural fibres/ man-made staple fibres not carded or combed ... OR... printing accompanied by at least two preparatory stages or finishing operations (e.g. scouring, bleaching, mercerising, etc.) where the value of the unprinted fabric does not exceed 47.5% of the ex-works price of the product”.

It is therefore important to examine these conditions of entry to the regional market and to gauge firm-level responses to this policy framework. With more stringent demand-side requirements, entry conditions for smaller firms in the regional market become specifically complicated and this may hamper indigenous business development prospects. This may also lead to specific market configurations, especially in terms of

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<sup>1</sup> A similar problem exists in relation to wheat and milling (Shoniwa 2000).

<sup>2</sup> The Cotonou Agreement will be replaced by Economic Partnership Agreements to be negotiated between the European Union (EU) and regional coalitions of African, Caribbean and Pacific countries which are currently party to the Cotonou Agreement. Negotiations between the EU and ESA (Eastern and Southern Africa – 16 countries in this region) began in February 2004.

seller concentration. If the entry of small firms is impeded, then it is possible that a small number of large firms may dominate markets such as clothing manufacture, not only in specific countries, but also regionally. From an industrial organisation perspective, this could have important implications for the nature and intensity of competition, and the prospects for small business development.

#### **2.1.4 Non-tariff barriers to trade: transaction costs associated with trade**

While the SADC Trade Protocol requires a systematic phase-down of tariffs by all member states, there are still many factors that may constitute barriers to intra-regional trade. Of these the lists of sensitive products are probably the most obvious, but the uncertainty associated with the range of invisible non-tariff barriers (NTBs) is likely to be the most significant obstacle to integration.

In terms of basic conditions affecting market structure, the single greatest obstacle to intra-regional trade is transaction costs faced by individual firms. Market access is largely obstructed as a result of excessive transaction costs.

The five most important NTBs according to Hess (2000) that impede trade in the region are:

- Communication problems
- Customs procedures and charges
- Transport problems
- Lack of market information
- Other border procedures
- Services: financial, electricity, technical support
- Standards and certification/technical restrictions

Again drawing on the theory of industrial organisation, the nature of the underlying market structure in which industries operate has significant implications for firm-level conduct and performance. Invisible trade barriers greatly increase the cost and risk of doing business, thereby affecting the competitiveness of firms in the global market and, above all, prohibiting access of smaller firms to regional markets. The role of these

factors as explanatory variables for low intra-regional trade should be considered in the formulation of industry support policies aimed at providing incentives for productivity enhancement, industrial development, investment and trade expansion.

Trade transaction costs are high in Southern Africa for several reasons. The economies of the region and patterns of industrial location and development have significant effects on transport costs between hub and spoke areas. The proportion of countries that are landlocked is much higher in Africa in general than in other developing areas, and Southern Africa has a significant number of landlocked countries. Transport is expensive and generally unreliable.<sup>3</sup> Insufficient competition is perhaps the most significant impediment to lower transport costs in the region. The lack of competition is reflected in privileges given to national airlines, nationally registered shipping cartels and monopolised sectors of the railway services (Collier 1997).

For the benefits of the FTA to be realised both the physical and the financial infrastructure of the region will have to be improved. Many of the services sectors in SADC exhibit significant market failures. Limited effective access to financial services increases risks, which can constrain investment, working capital needs and limit regional export development (absence of export credit guarantees) (Hodge 1998). The number of financial institutions in the region that specialise in non-traditional areas is extremely small (Musa 2000). Essential banking services include access to venture capital, credit facilities, trade financing, export credit guarantees and foreign remittances.

The lack of access to information and the presence of high transaction costs associated with information access impact negatively on the contestability of the regional market. Infrastructure required to facilitate and support integration include information dissemination mechanisms, communication networks such as trade fairs, marketing and investment promotion schemes, access to labour in labour-scarce areas and technology development schemes. Lack of access to information about trading partners, and investment opportunities and incentives, all contribute to hesitance on the part of firms to extend their undertakings within the region. Market development and

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<sup>3</sup> An apt example used by Collier (1997) to illustrate this point is that unreliable transport services force African firms to keep up to three months stock. In contrast efficient Asian producers are using "just in time" production methods which enable them to reduce inventories of inputs to only 20 minutes of production. Ironically the lack of financial services and flexible loans also means that keeping large inventories is much more costly due to the higher interest rates in African countries.

competitive pricing is severely constrained by such information inefficiencies; thereby further reducing market opportunities.

The ability of firms to build efficient supply networks is largely impeded by poor communication systems and the high cost of communication in Southern Africa. The unfortunate implication is that potential social capital development among the entrepreneurs and managers of firms is severely stunted. The telecommunications sector is riddled with shortcomings such as limited infrastructure, high cost, inefficiency and unreliability due to regulated or monopolised service provision (Collier 1997).

The mixed messages from conflicting policies within countries and between countries in the region are a further major deterrent to cross-border investment. Considering the unusually high transaction costs, the success of any form of integration will hinge on a radical reduction of transaction costs. Barriers to entry, whether visible (tariff barriers) or invisible (NTBs), increase the risk profile of doing business within the region and therefore directly affect the behaviour of firms.

The real message for policy makers is that invisible controls and barriers to trade are increasingly what prohibit industrialisation and general growth in the region. Eliminating direct costs of doing business and reducing the confusing signals given to firms will hold enormous benefits for the SADC countries. Such adjustments could increase trade and investment in the region and should thus restructure economic activity towards greater global competitiveness.

### **2.1.5 The role of unilateral, bilateral and multilateral trade agreements on market structure and market dynamics**

It is evident from existing trade patterns and from discussions with officials in different SADC countries that the pre-existing bilateral relationships between countries forged over time will continue to play an important role in determining intra-regional trade and industrial organisation in the region. Beyond the concluded trade agreements, these established networks greatly lower the risk and uncertainty involved in trading in a regional market.

### **BOX 1: BILATERAL RELATIONS WITHIN SADC**

Trade data for SADC and other sub-Saharan trade zones suggest that many of these countries tend to display trade patterns that reflect special bilateral relationships.

This has been specifically evident in trade between South Africa and Zimbabwe in the clothing and textile and other industries. Besides proximity between the two economies, political alliances between governments, as well as bilateral agreements between South Africa and Zimbabwe, have seen the development of strong trade linkages historically.

The breakdown and renegotiation of the South Africa-Zimbabwe trade Agreement in 1996, as well as the discontinuation of the export incentive scheme in 1994, have however led to a decline in Zimbabwean exports to the SACU. Muradzikwa (2000) notes that while Zimbabwean clothing exports to SADC increased (from 5% to 9%) in the 1990s, its exports to South Africa, the region's largest market, stayed constant due to high tariff barriers and quota restrictions. Recently unstable political and macro-economic conditions, and a high tariff regime have also contributed to the demise of the relationship between the SACU and Zimbabwe in the clothing and textile industry (Shoniwa 2000; Tyesi 2000).

South Africa also has trade agreements with Malawi, Mozambique and Zambia that have strengthened links between these countries and may become important in facilitating future trade integration.

Historic ties with Europe have been very important for Mauritius. Through the Lomé Convention between the European Union (EU) and African, Caribbean and Pacific (ACP) states important trade links were established between countries in the region and the rest of the world (Jhamna 2000). This is clear from the current export destinations from the Mauritian Export Processing Zone (EPZ), with Europe and the United States being the most important export markets. However, with respect to the textile and clothing industries, restrictive Rules of Origin continue to hamper penetration of the EU market. Some SADC countries record substantial clothing exports to the United States, but negligible exports to the EU, despite duty-free and quota-free market access. Nonetheless, in many cases bilateral ties with the EU are still much stronger than those with other ACP countries. In the case of the South Africa particularly, its isolation in the apartheid era meant that economic ties were forged with countries outside the region.

Although trade liberalisation within SADC is expected to enhance market access in the region, it is possible that pre-existing bilateral agreements within the region may remain important “pipe lines” for supply chain development and further vertical and horizontal integration of production lines, due to the lower risk and transaction cost profiles, from a firm perspective, associated with these agreements. This contention is strengthened by the acknowledgement in the

SADC Trade Protocol of the existence and maintenance of more advanced preferential trade arrangements among the SADC member states. These preferential arrangements remain in place until they are superseded by a more far-reaching regional trade arrangement for the SADC as a whole.

Bilateral agreements between specific SADC members and international trading partners present potential problems, such as the possibility of trade diversion, but also opportunities, such as technology transfers and learning by doing, for the region as a whole.

Besides many bilateral trade and customs agreements, most of the SADC countries have commitments under other agreements such as the Common Market for Eastern and Southern Africa (COMESA), the World Trade Organisation (WTO) and the SA-EU Trade and Development Cooperation Agreement (TDCA). These agreements have implications for the implementation of the SADC Trade Protocol, and may counter the effects of regional initiatives to foster integrated regional industrial development.

#### **BOX 2: MULTILATERAL AGREEMENT WITH NON-AFRICAN PARTNERS: TRADE AND DEVELOPMENT COOPERATION AGREEMENT (SA-EU TDCA)**

There has been much debate about the implications of the South Africa-EU TDCA for, for example, fiscal revenue and industrial development. Findings from preliminary research indicate a minor impact in these specific areas. The agreement also provides support for European and South African businesses with either a commercial or market presence in the region.

Two important implications of the SA-EU agreement are:

- Non-SACU, SADC firms will now face greater competition in the EU market, hence supporting South African (SACU) based firm development
- Because the region does not have a strong customs administration to monitor movement of goods, it is possible that products may enter via SACU and then spill over into the region resulting in competition for firms with local production (Shoniwa 2000). This is possible, for example, given the strong presence of South African retail firms in SADC countries, and the level of their imports from the EU.

A very interesting development from a regional integration and industrial organisation perspective has been the introduction of the African Growth and Opportunity Act (AGOA). AGOA was signed into law by then President Bill Clinton in May 2000. This Act offers preferential market access to a list of products from African countries that are declared eligible by the United States provided they meet certain requirements. AGOA preferences for exports of clothing products have motivated a series of investments in Southern African countries, especially least developed countries (LDC). LDCs are able to, in terms of the AGOA Rules of Origin, get the benefits of duty-free market access, while sourcing inputs from not only AGOA eligible countries or the United States, but also third party countries. These specific preferences are however time bound, currently available until September 2004. While this provides a current competitive advantage for these countries, this provision may mitigate against the incentive provided in the Rules of Origin of the SADC Trade Protocol for regional supply chain development. This is an important example of the incentive conflict that may emanate from different trade agreements, in this case AGOA and the SADC Trade Protocol.

Lesotho has seen a significant inflow of foreign direct investment attracted by the preferential market access offered by AGOA. To date the investments in the clothing industry have not lead to the development of regional supply chain linkages. The textile industry remains weak, and unable to provide inputs at the quality and price that would make them preferable to those sources from South East Asia, for example. Further, the exclusion of Zimbabwe from AGOA prevents producers in SADC from cumulating production using this historically important source of textile inputs. In addition, the clothing firms that have located in Lesotho and also in other countries in Southern Africa have not integrated into the local economies. The benefits of these investments, attracted by trade preferences, are thus limited, and the vulnerability of the recipient economies to relocations is obvious.

Officials of some of the SADC countries are making a concerted effort to introduce mechanisms to encourage investment in the region and are sourcing from the region as the importance of economic integration in the light of globalisation becomes more evident. The potential gain from multilateral and bilateral agreements, such as AGOA, that extend market access for SADC producers to the international realm is clear. On

the down side, the stringent requirements of many of these agreements imply less contestability of international markets for many of the SADC countries than is apparent.

The AGOA Rules of Origin have also prompted a series of firm relocations to less developed countries from South Africa and Mauritius. These relocations, of especially clothing firms, have negative consequences for the countries from which they relocate and benefits for those to which they move. From a regional perspective they may provide the basis for more balanced and sustainable regional development. However, the lesson from these AGOA-prompted relocations is that FDI is increasingly mobile, and that investments associated with industries such as clothing and textiles are perhaps not as secure in the longer term as they used to be. AGOA, with its provisions for full regional cumulation of production, has also had a positive impact on some supply chain linkages as countries not benefiting from the Rules of Origin waiver (South Africa and Mauritius) actively source textile inputs from within SADC.

One of SACU's main concerns is that the supply of various products from the region is insufficient to meet international order requirements. There is an on-going initiative to establish regional linkages to meet the requirements of AGOA in the clothing and textile industries to address this challenge (House 2000; Naumann 2001).

It is crucial to understand the role of established supply networks for the region as an important channel for lowering the transaction costs of doing business. In developing countries firms face very high transaction costs in manufacturing industries. Lengthy bureaucratic or customs procedures and the lack of access to information regarding trade and trading partners and investment opportunities and incentives contribute to hesitance on the part of firms when considering operating in the region. Transaction costs and associated risks are typically high when contract enforcement is difficult. In most of Africa and the regional business community, the only means of assessing creditworthy potential customers is through visual inspection.

It is in this context that established trade routes formalised by trade agreements become an important framework for investment and the development of supply chains. Importantly, trade liberalisation, whether multilateral, intra-regional, bilateral or unilateral, changes market access conditions, facilitating the entry of new products or

services into markets. This process of industrial restructuring also impacts the nature of the competitive process.

## **2.2 The impact of labour policy on regional market structure and location decisions of firms**

The influence of economic geography on the decisions of firms in the light of restricted mobility at a regional level in SADC is likely to present indications of a flying geese pattern similar to that observed in East and South East Asia. It is possible that the SADC may be heading for a similar pattern of relocation regarding industrial concentrations.

As O'Brien (1997) notes, with relatively high costs of labour, advanced labour legislation in South Africa and scarcity of labour in countries like Mauritius, we could envisage the relocation of labour-intensive parts of production processes to countries in the region with lower wages and a less skilled workforce.

Based on the comparative advantages of non-SACU SADC members, production facilities for value-added operations could also be established elsewhere in the region if existing commodities are extended through commodity value chains. The driving force for this relocation of investment is the increasing search for greater flexibility of factors of production in response to rapidly changing patterns of demand.

Recent relocations of firms from South Africa and Mauritius (Visser 2001; Jhamna 2000) are examples of such a pattern of industrial development. The changing nature of skills requirements in various industries is especially evident in the clothing and textiles industry where there is a rapidly changing demand dynamics.

For individual countries in SADC the importance of labour productivity and flexible labour markets in advancing competitiveness is paramount. Barring the influence that labour policy has on the cost structures of firms, low levels of investment in human capital may introduce uncertainty when considering returns on investments.

Restructuring labour policy is part and parcel of the long-term sustainability of any industrial sector in the SADC. Labour policy therefore not only impacts on micro firm

behaviour and local markets, but also sets the market structure at a regional level. Investment and location decisions will often hinge on differences between labour market flexibility, returns on capital and the predictability of the macroeconomic conditions. In this way labour policy can play an important role in the economic geographic pattern of industrialisation in the SADC.

### **2.3 Dynamic market processes**

The firm makes decisions to invest, to produce and to market its products or services taking into account technological considerations, factor costs, incentives, consumer preferences and market access conditions. These decisions and the conduct of firms in turn determine the dynamics and processes within a market. On the one hand, firm decisions are influenced by basic conditions (e.g. trade, labour and industrial policies) within the market. On the other hand, once the constraints wherein firms have to operate have been defined, changing market processes and the behaviour of firms based on the level of competition and demand-side requirements also start to shape the prevailing market structure.

As noted earlier, changing market access conditions may elicit investment decisions from incumbent firms or new entrants that establish not only a market presence but also a commercial presence, through, for example, a merger or acquisition. Such decisions may alter market structure significantly through the impact on seller concentration, and also alter the dynamics of competition by changing specific drivers of the competitive process (e.g. quality differentiation).

We discuss here some of the dynamics that are increasingly defining how trade is being conducted in the region. Given specific constraints such as high transaction costs and limited market-related information, alternative measures of conduct are being sought. There is a definite focus on deeper vertical and horizontal integration through cross-border supply chain development, networking and joint ventures. While there are many interlinking factors between these mechanisms of doing business at the regional level, the main features are lower informational costs and greater levels of innovation and

knowledge transfer and expansion of productive capacity, through inter-firm sharing.

### **2.3.1 Trade-investment linkages: FDI, joint-ventures and subcontracting arrangements**

FDI plays an important role in growth and may be an important stimulus to innovation. There is, however, a new awareness of the risks involved in the global market place, which has led to a significant move towards joint ventures, mergers and licensing agreements as mechanisms for investment.

The costs of producing and exporting new goods, as well as adopting new technologies, may be lowered through FDI, since foreign agents are likely to be more familiar with those techniques in the country of origin. The role of intra-firm transactions and joint projects between these companies and resident governments/firms is an important mechanism for technology transfer and knowledge sharing which will contribute to the expansion of value-added production and product differentiation within the region.

Already, the industrial strategies of various SADC countries are aimed at influencing investment patterns through joint ventures. This has a major bearing on the development of infrastructures, which is evident from mega projects in both Mozambique and Tanzania. There are also initiatives for infusing agri-processing in Mozambique through technology exchange in the walnut and cashew industries. This is based on joint ventures with the Industrial Development Corporation (IDC) and the Department of Trade and Industry (DTI) in South Africa (Sololo 2000).

Tanzania is engaged in a number of joint projects between its government and transnational companies (TNCs). This involves collaboration for the supply of gold and diamond extraction with Anglo American and De Beers. Instrumental arrangements between Tanzanian Breweries and South African Breweries have also resulted in the installation of a new plant and the modernisation of older equipment. Intra-industry trade becomes explicit in ventures like this through imports of packaging materials from the investing country (Musa 2000).

As noted earlier, relocation is also taking the form of transnationals, hosted in SACU and Mauritius, moving into the region by means of joint ventures and other inter-firm co-operation strategies. Networking or inter-firm co-operation is becoming an important link in the supply chain, with large and small firms increasingly focusing on core activities, while subcontracting parts of the production line to specialist firms to cut costs and to raise quality. As a result, FDI flows since the 1990s have been closely associated with growth in the number of SMEs and an increase in their share of the economic activity.

#### **BOX 3: THE ROLE OF SMES IN THE CLOTHING AND TEXTILE INDUSTRY – INCREASED COMPETITIVENESS AND ACCESS TO MARKETS**

There are many examples of flexible arrangements and subcontracting to SMEs by larger clothing and textile producers in South Africa. Co-operation among SMEs is, however, uncommon, while at the same time the limited capacity of these producers prevents them from entering into bulk delivery agreements with United States and EU buyers (House & Williams 2000). There may be scope for joint delivery by smaller producers across the region if policy could facilitate co-operation among them. This type of interaction could also serve as a mechanism for smaller firms with capacity constraints to pool outputs in order to supply larger global markets. Such arrangements therefore create opportunities for market entry by smaller firms that might otherwise be excluded from regional markets.

In the SADC market, trade liberalisation implies greater contestability of regional markets, but unidirectional exports from the SACU market to the rest of the region may restrict agglomeration of cluster areas within the region if factors of production are sourced exclusively from within South Africa.

#### **BOX 4: DISTRIBUTION OUTLETS WITHIN THE REGION**

An important business strategy of South African producers and specifically retailers has been an expansion of distribution outlets into the region. Although consumers in the SADC have benefited from the increase in variety, the infiltration of South African distributors everywhere in the region often displaces other retailers as well as producers along the domestic value chain (Kolala 2000). This trend has been witnessed in Zambia as well as in Zimbabwe. Very few of the inputs are sourced from host countries. Most South African firms use exclusively South African inputs, packaging and transport facilities. No industrial strategies have been formulated in any of the host countries to create incentives for sourcing from within the host countries.

From a policy perspective it is important that the timing of incentives aimed at drawing investment should be well synchronised. Non-tariff barriers raise the transaction costs of operating within local and regional markets considerably and provide a disincentive

for international firms to locate within the region. Policy plays an important role in lowering these non-tariff barriers and thereby increasing market access for potential investors.

It is in the interest of the developing countries to adopt domestic policies that encourage FDI and intra-industry activities. Such policies include the provision of key infrastructure and the development of human capital (e.g. skills upgrade and education) that would facilitate production and export in new sectors. Implementing multilateral agreements regarding basic telecommunications, information technology products and financial services would also substantially improve the region as a whole for further investment.

### **2.3.2 The role of intra-industry trade in regional integration**

Firms within the region have to operate increasingly in a globalised economy that increases market access but often makes it more difficult for smaller firms in the region to enter these markets. The changing dynamics of competitive processes between firms and within the market are demanding non-traditional patterns of trade and this in itself has a significant impact on prevailing market structures. If institutional structures and policy measures at an industrial level do not complement the needs of firms at the micro level, it is futile to hope that they may favourably influence firm-level behaviour at the market level.

Inter-firm organisational restructuring involves the transfer and assimilation of know-how and technology all along the supply chain. Information intensity prevalent at the micro level tends to accumulate at industry level. This requires dynamic interaction at all levels of the commodity chain, from conception through to production and the market. The role of networking and partnering relationships is instrumental in fostering knowledge diffusion and innovation.

In a study of 20 sub-Saharan countries undertaken by Hakura and Jaumotte (1999), it was found that intra-industry trade is a more effective channel for technology transfer and diffusion of information than inter-industry trade. Integrating foreign technologies and implementing new production methods seem to occur symbiotically in the sectors that are actively involved in trade and cross-country product sharing.

Cross-country production sharing and IIT(?) assist participating countries in becoming more fully integrated into regional markets and may also act as a catalyst to the industrialisation and growth of developing countries (Greenaway, Hine & Milner 1995; Yeats 2000). In fact, global product sharing, a process that largely consists of IIT, now accounts for 30% of world trade in manufacturing goods.

In a liberalised setting such as the proposed SADC FTA, the lowering of tariffs associated with liberalisation may lead to severe adjustment costs if the ensuing trade growth is of the inter-industry variety, specifically limiting the entry of infant industries. It is therefore important to understand how intra-industry trade may facilitate market access and reduce transactions costs associated with intra-regional trade.

Social networks encapsulated in cross-border intra-industry trade and commodity chains serve as an important mechanism for gathering information about manufacturing techniques as well as reducing problems of contract enforcement (Collier 1997). Whether in the form of economic clustering, intra-industry trade, supplier or trade associations, networking activities enable firms to forge economic ties to facilitate risk sharing and encourage joint production and development. The involvement of firms in reciprocal and co-operative contracts or agreements is closely linked to the growing complexity of production systems and the demand for horizontally and vertically differentiated products (Morgan 1998).

#### **BOX 5: THE ROLE OF NETWORKING, FDI, AND JOINT VENTURES AND SUBCONTRACTING IN FACILITATING PRODUCTION AND INNOVATION**

There is significant potential for firms to learn and to expand their technological capability through extensive, active networks with foreign technology suppliers and foreign partners. Technical innovation spans a great many areas including skills and adaptability of the workplace, the efficiency with which resources are used and the rapid adaptation to new techniques. Investment in education and training to improve labour's efficiency in the production process is therefore as important as fixed capital investment in plants and machinery.

Whether local firms can harvest these learning opportunities offered by foreign connections is largely dependent on the timing and sequencing of policy developments and the "policy dynamics" embodied in domestic policies and the regional agreements in place.

The success of networking stems from the fact that firms learn most from other firms and that this interactive, inter-firm learning is a key ingredient of the innovation and diffusion process. Interactions take place among firms, between firms and customers, at research and development (R&D) centres and with suppliers of technologies. Further to this, the movement of skilled labour between firms and countries is also an important vehicle for the sharing of technical information and learning.

Inter-firm R&D partnerships are starting to emerge among firms in the developing world. Mytelka and Tesfachew (1998) provide examples of agreements between the national mining companies of Peru and Bolivia to develop metals and biotechnology, and between South African and Kenyan firms for the transfer and development of technology in the forestry industry.

Ernst, Ganiatsos and Mytelka (1998) highlight the role of subcontracting arrangements between foreign and local clothing and textile producers in enhancing the transfer of technology and information sharing in Asia. In this case the foreign partner supplies inputs such as patterns, cut pieces and accessories to local firms and subsequently markets the finished garments. The supply chain therefore becomes the conduit for technical assistance in plant operation, quality control and management routines.

Critical lessons for African governments about conduct under competitive market conditions have emerged from East Asia. One of the key principles that regional governments have to embrace is that industrialisation does not rely on market forces alone. On the contrary, it emerges from a process that includes a visible set of well co-ordinated policies that aim to stimulate and support learning and innovation within the firm and the economy proactively.

Mytelka and Tesfachew (1998) summarise the interrelated factors that influence learning and innovation at a policy level as follows:

1. The types, timing and sequencing of policy instruments used
2. The interaction between policies and their effect on the behaviour of firms
3. Policy dialogue that involves all principle participants at the micro and market levels
4. Synthesised policy to strengthen market forces and thereby minimise cross signals in setting the parameters within which enterprises make decisions with regard to innovation, investment and exporting

The knowledge intensity of production and its generalisation along supply chains has become crucial in the global competitiveness game. Institutions that enhance education and training create the human capital that can accommodate rapid changes in production and provide the skills necessary to facilitate technological progress.

### **3. Conclusion: How can policy formulation improve the prospects for regional integration?**

The interplay of trade, labour and industrial policy measures at a national as well as a regional level often provides confusing signals to firms engaging in production and cross-border trade. Even within only the trade policy arena, there are conflicting incentives arising from Rules of Origin provisions in various agreements or arrangements, quantitative restrictions and exclusions of certain products from trade liberalisation policies. The lack of policy co-ordination, and the often conflicting policy aims and directions of the participating member states can negate any attempts at stimulating economic growth within the region.

Concerns about the imbalances in industrial development in SADC have been addressed by various authors including O'Brien, (1997), Von Kierchbach and Roelofsen (1998) and Kalenga (1999). There is concern that the dominant role of SACU in the regional market may polarise investment and industrial development more as SADC becomes a free trade area. One of the main objectives of a regional strategy should be to counter the existing tendency towards economic polarisation and industrial concentration. This can only be achieved through greater contestability of the regional markets. In addition to a FTA, contestability at the regional level will have to be redressed by lowering the transaction costs of doing business at a micro level. New Growth Theory predicts that with the advance of regional integration, if, for example, labour mobility does not improve, while transaction costs associated with trade fall, the role of supply chain development and diversification of networks becomes increasingly important as a vehicle for growth.

The impact of trade, labour and industrial policy on market structure and economic geography in the region is crucial. It is important that learning about the impact of these related policies happens at all levels of the economy (firm, industry and macro levels). The key to facilitating intra-regional industrialisation and socio-economic progress lies in the support and accelerated development of industries where SADC has a comparative advantage. Integration of industrial and agricultural production activities is the most promising area for increasing value-added production within the region.

The relative inflexibility of labour agreements in South Africa and the scarcity of labour in countries such as Mauritius could lead to the relocation of labour-intensive parts of production processes to countries in the region with lower wages and a less skilled workforce. This has already happened recently as Mauritian clothing firms have relocated their mass production activities to Madagascar and even Tanzania and Mozambique. Based on the comparative advantage of non-SACU SADC members, production facilities for value-added operations could also be established elsewhere in the region. Rigidities in the existing market structure due to costs and information asymmetries are, however, preventing this from happening. While some of the less developed countries in the region have a comparative advantage in the production of low value-added commodities within a supply chain, the relative difference in the cost of labour between countries will not secure these advantages in the longer term unless certain dynamic shifts in terms of technological acquisition and human resource development are prioritised. Industrial and labour policies are therefore vital to developing long-term strategies for regional development.

Trade policy can be an effective measure used to facilitate industrial restructuring in the short and medium term. Governments should however be wary of searching for short-term results that may be attained through visible policy instruments. Only if the measures taken by governments signal predictability and market contestability will industry actively engage in expanding its activities in the region.

Understanding firm-level responses to policy provides significant insights for policy makers and analysts. The industrial organisation framework, which

focuses on firms and markets and the interaction between them, provides useful guidance in this task. Examining how and why firms respond as they do to policies and market signals can assist policy makers to co-ordinate national policies, and to tackle the even more challenging task of co-ordinating policies across national boundaries. A very significant development in this regard is the new SACU Agreement which explicitly provides for the co-ordination of industrial policy and also requires that all SACU member states have a competition policy.

In order for policy interventions to facilitate the strengthening and broadening of industrialisation at a regional level, they have to **complement** the **dynamic processes**. This includes taking into account FDI flows, joint ventures and supply chain developments between and within firms in the SADC. The micro foundations that underpin the basic notion of industrial organisation have to provide a platform for the macro policy measures aimed at regional industrialisation.

As SADC moves towards a FTA, firm-level decisions are critical in integrating the economic space of the region which is currently fragmented by policy barriers and inconsistent policy incentives, and the high transaction costs of doing business. Intra-regional trade liberalisation can play a key role in motivating cross-border economic activity, but it is not sufficient to ensure that the region becomes an integrated economic space. For that to happen effective national and regional policy co-ordination and the significant reduction of the risks and costs of doing business in the region are imperative.

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