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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

South-South Trade: Vital for Development

Introduction

The most effective way to make trade work for development and poverty reduction is for countries to agree on much improved market access under the Doha round of talks at the World Trade Organization (WTO). Ambitious trade liberalisation can generate more gains for developing countries than any other area of international economic co-operation or development assistance.

These arguments are a familiar theme of the Doha discussion. But while access to OECD markets is clearly a key element in developing countries' productivity growth, that is only part of the story. Trade between developing countries is also vital – indeed, research clearly demonstrates that if developing countries want to reap the maximum gains from multilateral trade liberalisation, they too need to open up their markets and boost trade among themselves.

Trade between developing countries (South-South trade) offers wide scope for specialisation and efficiency gains. At present, barriers to South-South trade are higher than those governing South trade with other partners, and distance-related costs are higher. Recent OECD research shows that the potential benefit from freer South-South trade may indeed be at least as large as the gains that developing countries can obtain from better access to rich countries' markets (North-South trade). There is certainly room for South-South trade to develop – it is estimated that exports from one developing country to another account for just 6% of total world merchandise exports, while South-South trade in services overall makes up just 10% of world total.

This not only underscores the importance of a successful conclusion of the current round of WTO negotiations but also the significance of active participation by developing countries. ■

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How has South-South trade been evolving?

South-South merchandise trade has expanded considerably in the past 20 years, albeit from a very small base: it now makes up around 6% of world trade, compared with 3% in 1985. Over that period, South-South merchandise trade grew on average at the impressive rate of 12.5% a year, compared with 7% for North-North trade and 9.8% for North-South trade. But tariff barriers affecting South-South trade are still much higher than those affecting other trade, at an average 11.1% compared with 4.3% for North-North trade.

South-South trade has become relatively more important as a share of total merchandise trade involving the South, rising from less than 10% of the total to around 14%. But the bulk of total goods trade involving the South is still accounted for by trade with the North. South-South merchandise trade displays a significant geographical concentration in developing Asian countries. What is more, South-South trade mostly involves upper-middle- and lower-middle-income countries which account for between 3% and 5% of total world trade; exchanges involving low income countries make up barely 1% of total world trade. This situation is unlikely to change since growth in the value of exchanges involving low income countries shows a significantly slower growth trend than for others. There are also significant differences in the products involved in South-South merchandise trade as compared to North-South and North-North trade. Broadly speaking, South-South trade seems to be more concentrated on raw materials and less processed products than either North-South or North-North trade, probably due to differences in factors affecting both the demand and the supply sides.

On the trade in services side, the limited data available make it extremely difficult to measure the size and direction of trade flows. A first attempt by the OECD to investigate the nature and scale of such trade indicates that in 2002, South-South total services exports (covering cross-border trade, movement of consumers, and, to a limited extent, the movement of services suppliers) represented around 10% of world services exports. There are however important sectoral differences. For example, while South-South exchanges play an important role in world tourism, certain other services such as air transport are estimated to be still heavily dominated by North-North and South-North flows.

As with merchandise trade, significant geographical concentration of South-South services exports is apparent: exports from Asian developing countries represent around 8% of total world exports, and exports to other developing countries account for more than half of their total exports. Similarly, there is some evidence that for certain Asian and Latin American developing countries, trade with other developing countries exceeds 50% of their total services trade. For the rest, exports to developed countries appear to be more important.

The most important conclusion to emerge from this work is that services trade between developing countries takes place predominantly at the regional level for cross-border trade; movement of consumers; commercial presence and movement of suppliers. This may be due to the increasing tendency to include liberalisation of services trade in regional trade agreements. ■

What are the gains from more open South-South goods trade?

Research at the OECD suggests that the recent growth in South-South goods trade has not been brought about by the so-called "death of distance" – the large drop in the cost of moving people, objects and ideas around the globe observed in the 1980s and 1990s. The impact of distance-related trade costs has not noticeably diminished over the period and such costs continue to have a much more negative effect on South-South than on North-North trade. Whereas a 10% increase in distance between countries or regions tends to reduce North-North trade by about 10%, the comparable figure for South-South trade is 17%. In both cases, the figures estimated for 2002 are scarcely different from those for 1985. However, given that the distances facing South-South trade are broadly comparable (on average) to those facing North-North and North-South trade, there is considerable scope for increasing South-South trade by reducing distance-related trade costs to levels prevailing for other trade flows.

It can also be demonstrated that the importance of a common language for South-South trade increased markedly in the early 1990s (*e.g.* trade among French-speaking Africa), but remained approximately constant for other trade flows. Hence, ethno-cultural links may have been one factor in the observed growth of South-South trade around that time.

The evidence currently available suggests, however, that policy barriers are much more important for South-South merchandise trade than for other trade flows. On average, a 10% tariff cut is estimated to be associated with a 1.6% increase in exports. This could translate into an additional USD 5.7 billion in export earnings a year (based on 2002 data). Interestingly, the data indicate that an equivalent reduction in North-North or North-South tariff barriers would have a lesser impact on trade flows. This suggests a considerable scope for trade policy to boost trade between low- and lower-middle-income countries, and thus help boost economic development and reduce poverty. Indeed, model simulations of tariff reductions performed by the OECD suggest that, from a development point of view, liberalising South-South trade is at least as important as tariff-free market access to Northern markets. This seems to be particularly the case for agricultural products, but projected gains from liberalising South-South trade in manufactured goods are also substantial (Table 1).

The observed geographical patterns of South-South trade imply that about half of the gains from future South-South tariff liberalisation would be realised by low and middle income countries in Asia. Additionally, most of the gains from South-South liberalisation in Asia would be regional. In other words, countries would benefit most from liberalised trade with their geographical neighbours. One prominent exception to this rule is China which is actually estimated to gain more than twice as much from liberalisation of trade with Latin American, MENA and sub-Saharan countries than from liberalisation with other Asian countries. The picture is slightly different in Latin America and sub-Saharan Africa where regional gains account for respectively 45% and 39% of gains from South-South trade – almost all the remaining gains can be attributed to trade with low and middle income countries in Asia.

It also appears, however, that only a part of the potential gains from South-South trade could be realised through regional agreements, mainly in Asia. More generally, many low and middle income countries benefit most from freer trade with similar countries in other regions. This points to multilateral negotiations as an important vehicle for realising the gains from South-South goods trade. ■

What are the gains from more open South-South services trade?

In the case of services, the elements that influence trade, including policy factors, apply to South-South trade in much the same way that they do to other forms of trade. But the effect of distance on South-South trade in services appears to be less strong than for goods trade, according to recent OECD research on foreign direct investment

Table 1.

WELFARE GAINS FROM A WORLDWIDE REMOVAL OF TARIFFS ON MERCHANDISE TRADE (USD BILLION)

	All sectors			Manufacturing			Agriculture		
	Liberalisation action			Liberalisation action			Liberalisation action		
	World	North	South	World	North	South	World	North	South
Gains accruing to:									
World	68	29	39	33	9	24	35	21	14
North	29	10	19	13	-3	16	16	13	3
South	39	20	19	20	12	8	20	8	11

Source: OECD (2006a).

(FDI) stocks in services. This is consistent with the idea that the main cost involved in services trade is information, rather than transport which pushes up the cost of goods trade. But the analysis also points to the importance of policy barriers, and implies that countries could increase trade in services across all sectors by relaxing restrictions on foreign establishment.

Services liberalisation is also found to have a positive impact on merchandise exports through cheaper transport, communication, and financial infrastructure. In addition, productivity gains in services which are direct inputs into producing merchandise can increase the competitiveness of firms. In developed countries these effects are comparatively weaker because the share of manufacturing and supply of exported goods in gross domestic product (GDP) tends to decrease as economies mature. In developing countries, however, service sector performance is a significant factor explaining merchandise exports. Services are particularly important where manufacturing activities are large-scale and require specialised labour, many intermediate inputs, and raw materials from geographically dispersed small-scale suppliers.

One significant fact to note is that the impact of lifting restrictions on performance may increase more than proportionally with the scale of the liberalisation measure. This may mean that it is not enough to liberalise moderately in order to achieve an impact on performance if the initial degree of restrictiveness is high. Preliminary results suggest that if services sectors are closed to foreign competition, the improvement of their performance requires a major rather than a small or moderate liberalisation effort. More research is needed to further assess whether a courageous liberalisation effort is required for notable improvement in outcomes, which may particularly benefit goods exports of less developed countries. ■

Is South-South trade subject to higher barriers?

South-South merchandise trade is still generally subject to much higher barriers than North-South or North-North trade. Overall, the barriers facing South-South trade are estimated to be almost three times higher than those facing North-North trade (Table 2). But individual tariff rates vary widely across the South, and the poorest countries

Table 2.

SIMPLE AVERAGE TARIFF RATES, 2001, BY EXPORTER AND IMPORTER GROUPS

Exporter \ Importer	North	South
North	4.4	9.9
South	5.0	11.1

Source: Dihel, Kowalski and Shepherd (2006), calculated from MAcMap data.

tend to be those with the highest tariffs. Protection levels increase as the exporter's income level decreases. This means that bilateral trade between the poorest countries tends to face the highest barriers.

In the services area, analysis by sector shows that a high number of developing countries continue to impose restrictions to a level well above the OECD average in banking, insurance, telecommunications, distribution and engineering. Restrictions on services in different sectors are measured by a trade restrictiveness index (TRI). Results in banking services for selected countries (Figure 1) show that Asian non-OECD developing countries are the most restrictive group in this sector, followed by Russia and selected Arab countries. ■

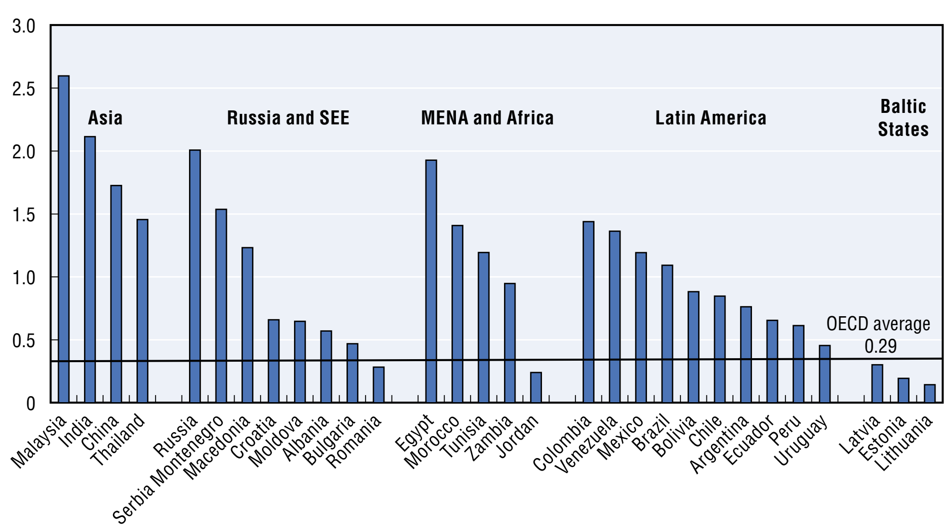
What prospects for the future?

The economic stakes in the Doha Development Agenda negotiations at the WTO are high. The process of global integration is far from complete and substantial gains from international specialisation remain untapped. Despite the considerable progress achieved in the first eight rounds of negotiations, research shows that there is still ample scope for benefits to accrue from further multilateral tariff liberalisation alone. In terms of shares of gains in national incomes, developing countries as a group stand to gain more from multilateral tariff liberalisation than industrial countries; and these gains depend significantly on the extent to which developing countries themselves open up their markets.

An agreement that achieves deeper liberalisation in services would generate significant additional benefits for all WTO members, including developing countries. What is ultimately at stake in the DDA is whether

Figure 1.

AGGREGATE TRADE RESTRICTIVENESS INDEX – BANKING



Source: OECD (2006b).

governments will garner the political resolve in support of a shared vision to maintain and strengthen the rule-based trade environment in which growth, development, poverty eradication, better jobs and improved social and political conditions can be facilitated and encouraged.

The analysis of recent trade and macroeconomic trends further suggests that the stakes associated with South-South trade are constantly expanding in tandem with the potential for gains that can be achieved through reforms of trade policies of South countries. This is associated with the fact that countries in the South record generally higher rates of income growth than developed countries and both merchandise and services trade of the South is growing at higher pace as compared to the North. If this trend continues, the balance of gains from trade policy reforms will continue shifting in favour of South-South trade, making the case for low and middle income countries to participate actively in the multilateral trading system even stronger. ■

For further information

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For further reading

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