AN EU-SOUTH AFRICAN FREE TRADE AGREEMENT:

HOW WILL SOUTH AFRICA BENEFIT?

BY SHIRLEY ROBINSON

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CHAPTER ONE

Introduction

South Africa's accession to the international trading community following its transition to a political democracy in April 1994 has initiated changes to trading relations with its major trading partners, over and above multilateral negotiations under the General Agreement of Trade and Tariffs (GATT), and its successor, the World Trade Organisation (WTO). The normalisation of international trading relations has necessitated a complete overhaul of appropriate trade policy regimes. These changes are taking place within the context of shifting domestic policy and heightened international trade diplomacy, and for the most part are confined to country-/ region-specific negotiations, particularly the United States of America (USA) and the European Union (EU).

Economic and political associations between South Africa and the EU have always been strong, a direct result of historical and cultural links. Consequently, the EU has been and remains an important source of trade and investment for South Africa. South African exports to Europe (excluding gold, which serves to distort trade flows) and imports from Europe increased during the 1970s, tapered off during the early 1980s mainly due to heightened political tensions, but resumed growth towards the late 1980s (Cassim and Hirsch, 1994).

At present, the 40% of South Africa's imports are sourced from the EU, while the EU demands about 33% of South Africa's exports[1] (IDC, 1995). Although most of South Africa's exports to the EU comprise agricultural and primary products, trends indicate growth of manufactured exports to the EU. In addition, imports of capital equipment from the EU will increase rapidly should the South African economy continue on its upward growth spurt, causing a rise in fixed investment (Cassim and Hirsch, 1994).

The European Union remains an important source of trade for South Africa, and integration of the new democracy into the world economy requires *inter alia* the creation of an appropriate trade policy regime between South Africa and the EU that is mutually

[1] Refer to Tables 1-4 in Appendix 1, IDC, 1995.

acceptable and beneficial. In its bid to fashion a framework for co-operation with South Africa on trade, political and economic fronts, the European Union (EU) initiated negotiations on the formation of an asymmetrical free trade accord with South Africa at the end of 1995. These negotiations form the second tier of the European Union's approach to normalise trading relations with South Africa in a manner that facilitates economic growth and development in the emerging democracy.

The first part of the EU recommendations involves a partial integration of South Africa into the Lomé convention for African, Caribbean, and Pacific (ACP) countries. The Lomé Convention is the EU's premier trade concession accord offered to its trading partners. Initiated in 1975, it offers 69 developing countries in the ACP group trade concessions and a range of non-trade assistance measures. Although each Convention was specified to cover a five year period before re-negotiation, Lomé IV, completed in 1989, is stated to run for ten years until the year 2000[2] (Dearden, 1992).

Partial access to Lomé IV would enable South Africa to enter into political dialogue with the EU, but would exclude it from any trade concessions conferred to Lomé members (Business Day, 1995). Exclusion is premised on the comparatively more developed status of the South African economy when viewed against the backdrop of Lomé membership. Whilst some might consider complete access to the provisions of Lomé IV preferable, the re-negotiation of the Convention within five years poses a threat to any concessions which South Africa might gain. Declining economic growth in the European Union[3] in the 1990s is likely to curtail the future offer of non-reciprocal agreements in favour of those regional/ 'economic' integration agreements which allow reciprocal market access, such as free trade areas.

The second leg of the EU's proposals - an asymmetrical free trade agreement - is intended to place trading relations with South Africa on par with similar developing countries within the EU's hierarchy of trade preferences. The free trade agreement will permit an asymmetrical phase-in period for tariff reduction, allowing South Africa to hone its industrial competitiveness[4] before opening its markets to European products.

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[2] It is also uncertain whether a further Lomé Convention, i.e. Lomé V, will be negotiated in the year 2000.
[3] Refer to discussion on international growth trends in Cassim and Kuper (1996).
[4] The term 'competitiveness' is open to a variety of interpretations. Here, 'competitiveness' is defined at the national level in terms of national productivity. Porter (1990:6) states that. "The principle economic goal of a nation is to produce a high and rising standard of living for its citizens. The ability to do so depends...on the productivity with which a nation's resources (capital and labour) are employed ...

The proposed free trade area (FTA) is not without controversy. There is discord among the 15 member countries of the EU. France, in particular, is calling for detailed studies on the impact of a free trade accord on EU economies (specifically on the sensitive industries covered by the Common Agricultural Policy (CAP)[5]), on the EU's trading partners, and questions whether such an accord would comply with the regulations set by the World Trade Organisation (WTO) on free trade.

The same disagreement among the EU membership delayed the passing of a mandate for the European Mission to even *begin* talks with South Africa on the formation of a free trade area. In March 1996, EU ambassadors eventually agreed to pass a mandate to negotiate a FTA with South Africa, excluding at least 39% of South Africa's agricultural exports from preferential access to the EU market (Business Day, 1995).

Extensive exclusions of agricultural products have angered South African trade diplomats, as the present trade mandate is far less generous to South Africa than previously proposed. In addition, Article XXIV of the GATT, as amended by the Uruguay Round, permits the formation of a free trade area provided that it is implemented within a reasonable length of time not exceeding ten years, and that trade barriers are eliminated on *substantially all* the trade between partners by the end of this period (Stevens and Kennan, 1995). South African trade negotiators have questioned whether South Africa should even enter into further negotiations, unless exclusions under the present mandate are reconsidered and themselves tabled for negotiation.

The major stumbling block to the negotiation of a free trade area between the EU and South Africa appears to be the possible threat of South Africa's agricultural exports to those 'sensitive products' covered by CAP, specifically deciduous fruits and vegetables. The Mediterranean bloc of the EU (France, Portugal, Greece and Italy) is particularly concerned about the flooding of South African deciduous fruit and vegetables on the EU market, jeopardising their domestic agricultural sectors. In addition, the EU fears that the signing of a free trade accord with South Africa might set a precedent and trigger a flurry of demand for equally preferable agreements from the EU's other trading partners, particularly Latin American and Mediterranean countries and the USA.

[Productivity] depends on both the quality and features of products (which determine the prices they can command [on the domestic and international market]) and the efficiency with which they are produced".

[5] For a full discussion on CAP, see El-Agraa (1990: ch. 9).

Concern over the setback suffered by the European Commission to negotiate a long-term trade and economic co-operation agreement with South Africa runs high. It is feared that the twin-track approach of South Africa's partial access to Lomé IV and the negotiation of an asymmetrical free trade accord with the EU will be jeopardised[6]. The European Commission had hoped to conclude negotiations on a free trade agreement with South Africa by mid-1996 so that its implementation would coincide with the revised Lomé Convention for ACP countries in January 1997 (Business Day, 1995).

In addition, the delay in negotiations intensifies the waning international concern over South Africa's political and economic transition. The agreement should be negotiated while South Africa retains the interest and assistance of the international community in building a sustainable democracy. These international pressures will advance South Africa's call for a beneficial EU-South Africa FTA that will facilitate economic growth and development in the nascent democracy.

While there seems to be a certain degree of haste for the normalisation of trading relations between South Africa and the European Union for strategic reasons, there has definitely been a lack of sufficient research to assess the likely economic impact of a free trade agreement for both partner countries. This is precisely the argument of French trade lobbyists. On the South African side, the resignation of the South African ambassador to the EU, Neil van Heerden, in January 1995 without the immediate appointment of a successor as chief trade negotiator, left the South African team without a strong leader in negotiations, contributing to further delays. Economist Elias Links, appointed in July 1996 as the South African ambassador to the EU, takes on the responsibility of resuming trade talks with the EU, providing a strong lead to the South African negotiating team (Business Day, 1996).

The key question asked is: '*Will South Africa benefit from the signing of a free trade area with the European Union*?' Most of South Africa's exported products already enter the European Union at modest tariff barriers under the Generalised System of Preferences (GSP). The GSP concession is severely limited as it forms the lowest rung of the EU's hierarchy of trade preferences. Many of South Africa's competitors enjoy greater access

[6] Given the late resumption of negotiations in July 1996, and the fact that the South African delegation has yet to produce a mandate to present to the EU, South Africa will be unlikely to conclude a FTA with the EU before 1998 (Business Day, 1996).

to the EU market. A supplementary trade agreement is necessary to accord South Africa equal competitive advantage in the EU market.

However, a FTA implies different welfare effects for the member countries. The debate is whether South Africa would experience a *net gain or loss in the short-term*, and whether *dynamic gains would accrue in the longer term.* What are the *opportunity costs* for South Africa of locking-in to a FTA with the EU? What are the *alternatives* in the design of an *appropriate trade regime* with the international community and the EU in particular? Will an EU-South Africa FTA *aid growth and development in the longer term*, or will it merely *bias trade expansion* towards the EU?

EU negotiators openly admit that most of the burden of tariff reduction in the agreement will lie on South Africa. In addition, furore over sensitive agricultural products covered by CAP will probably lead to the exclusion of about 39% of South Africa's agricultural exports from the free trade accord, unless otherwise negotiated. This will alleviate EU fears that the European market will be flooded by South African fruit and vegetables, in particular.

On the South African side, concern is rising about the *impact of further accelerated tariff reduction on restructuring of South African industry,* specifically employment-sensitive areas such as the clothing and the automotive industries. Article XXIV of the GATT provides a maximum of ten years for the phasing-in of tariff reductions. The negotiation of an asymmetrical free trade area with the EU will allow South Africa to phase in tariff cuts over the maximum period for 'sensitive' industries, whilst the EU is bound to a shorter phase-in period, unless a particular case is considered by both to be exceptional.

These concerns are valid in the context of high and rising unemployment in South Africa, and in view of the fact that the least-economically active regions will bear the brunt of probable employment losses, exacerbating income inequalities in South Africa.

This paper will attempt to answer the over-arching question: '*Will South Africa benefit from a free trade agreement with the EU*?'[7] It will not attempt thorough empirical analysis of this question. Instead, it will offer theoretical insight to certain of the policy

[7] This paper forms the basis for Robinson, S., 1996, An EU-South African Free Trade Agreement: How Will South Africa Benefit?, Trade Monitor, Vol. 14, Trade Policy Monitoring Project, University of Cape Town.

questions raised about the proposed EU-South Africa FTA[8]. The relevant body of theoretical literature is one which will facilitate an economic assessment of the impact of the proposed EU-South Africa FTA by considering short-term benefits and losses, in addition to longer term dynamic gains, of trading agreements between two countries. Regional integration, appropriately modified, can deliver this body of theory. That is, it does raise the key issues in assessing the necessary costs and benefits of further integration on both trading partners.

Although the proposed EU-South Africa FTA cannot be considered to be 'regional' integration by pure definition, it is certainly a variant of 'economic' integration. Consequently, an entire review of regional integration theory is not necessary for the purpose of an analysis of the proposed EU-South Africa FTA. A *tailored* theoretical review will present the necessary analytical tools that will facilitate debate on the key questions raised concerning the EU-South Africa FTA. In addition, recent developments in new growth theory will augment dynamic critique in explaining how 'economic' integration may contribute to longer term growth and development in a developing economy such as South Africa. This will provide the backdrop for discussion on the policy implications of an EU-South Africa FTA, specifically for macroeconomic policy reform within the context of socio-economic transformation in South Africa.

The Second Chapter undertakes a tailored review of regional integration theory. Chapter Three takes a closer look at the dynamics of a free trade agreement, analysing the static and dynamic[9] implications of an EU-South Africa FTA for South Africa. Chapter Four considers the policy implications for the South African economy of of an EU-South Africa FTA, particularly in regard to its complementarity to, and support of, the government's recently released medium-term macroeconomic strategy, 'Growth, Employment, and

[8] This dissertation, entitled "An EU-South African Free Trade Agreement: How will South Africa benefit?", is policy-orientated in focus. A mini-thesis, it does not attempt to address empirical analysis of the proposed EU-South Africa FTA, as would a full length thesis. Instead, the paper offers theoretical and critical insight to policy applications in the debate on the FTA with the EU. Regional integration theory, appropriately modified, is a tool used to facilitate and further policy discussion, and to analyse empirical studies. Consequently, theory forms the backdrop to policy discussion, rather than taking centre stage in a detailed theoretical discussion of regional/ 'economic' integration.

[9] In theory, static equilibrium may be defined as a configuration of economic variables, which once attained, does not change over time. In contrast, dynamic equilibrium in which the variables in question change systematically over time (Bannock et al, 1972). This paper has taken the more generic usage of the term. Here, static gains and/or losses may be defined as occurring in the short-term, i.e. their effect is immediate. Whereas dynamic gains are medium- to long-term effects - a culmination of effects seen over a certain time period.

Redistribution'. Chapter Five concludes this paper, opening the debate and calling for further research on issues raised.

CHAPTER TWO

The Theory of Regional Integration

2.1 Different Forms of Regional Integration

Regional integration is primarily concerned with the "discriminatory removal of all trade impediments between the participating nations and..the establishment of certain elements of co-operation and co-ordination between them" (El-Agraa, 1985:1). Co-operation and co-ordination may take on a variety of forms. Essentially these are:

- Free trade areas (FTA) - where member countries remove all trade barriers between themselves, but retain discretion as to their trade policies regarding the rest of the world. The European Free Trade Association (EFTA), North American Free Trade Agreement (NAFTA), and the Australia-New Zealand Closer Economic Relations Trade Agreement (ANZCERTA) are particular variants of free trade agreements.

- Customs unions - similar to free trade areas, but where the member countries pursue common external trade policies. That is, they must adopt common external tariffs (CETs) towards imports from the rest of the world. The Southern African Customs Union (SACU) is a recognisable example of a customs union.

- Common markets - are customs unions where factors of production (capital, labour and enterprise) are fully mobile across national boundaries between member countries; for instance, the East African Community (EAC) and the EU in a particular fashion.

- Complete economic unions - which are common markets bound by unified fiscal and monetary policies regulated by a central authority. The EU is moving towards establishing the European Monetary Union (EMU) with the creation of a single European currency - the euro - in 1999.

- Complete political integration - where member countries effectively amalgamate into one nation governed by a central parliament.

Regional integration may take on any one of the above forms, or a variant of such. The above should not be viewed as *stages* in a process, but as independent regional agreements which do not necessarily ultimately lead to political integration (El-Agraa, 1985).

The proposed EU-South Africa FTA is a variant of the classical FTA in that it allows for the negotiation of an *asymmetrical* agreement. In addition, it is not intended as a movement towards complete political integration, as is intended within the EU itself, but as an independent 'economic' agreement that will facilitate trading relations between the two states.

Regional/ 'economic' integration may be characterised as both *negative* (the removal of trade restrictions in the course of trade liberalisation between member nations) or *positive* (the modification of existing institutions or the establishment of new institutions or arrangements that aim to promote the efficient and effective operation of the regional agreement). Essentially, free trade areas and customs unions may be described as requiring only negative integration, whilst the remaining necessitate both positive and negative integration (El-Agraa, 1985). Both regional and 'economic' integration agreements may be fashioned to suit individual circumstances, and therefore are not cast in stone, but may be modified as required by the proposed member countries.

This is of particular note in the proposed EU-South African free trade agreement. The end agreement, once negotiated, is unlikely to approximate the classical notion of a FTA. It will most certainly be tailored to suit the particular needs and demands of both partner countries. The EU's exclusion of 39% of South Africa's agricultural exports of those sensitive products covered by CAP is particularly contentious in the FTA negotiations. This will most probably lead to dilution of assumed potential static trade creation gains to South Africa as proposed in initial EU deliberations.

South Africa would be wise to request certain *positive* institutional inclusions into the FTA with regard to joint endeavours in education, training and technological transfer[10]. This would enable the emerging democracy to accelerate the accumulation of human capital and technological capability, as well as improving its investment climate - the groundstones of a vibrant economy.

[10] Individual countries (particularly France and Germany) within the EU have proposed *co-operation* agreements, specifically with regard to training and the accumulation of technological expertise (Business Day, 1996).

The questions to be asked throughout this paper are '*Why* should South Africa enter into a bilateral trading agreement with the EU? *What* are the relative benefits for South Africa of a FTA with the EU over multilateral trade negotiations under the WTO?'

Arguments at a static level, based on the theoretical literature of trade creation and trade diversion, will provide the backdrop against which recent empirical studies on the proposed EU-South Africa FTA will be considered. Theoretical insight into the longer term benefits of an expansion of international trade will facilitate broad analysis of the potential dynamic gains attributable to the proposed economic integration agreement.

Recent EU-South African trade negotiations underscore a deeper international debate over the relative merits of regional/ 'economic' integration agreements over those of multilateral trade negotiations, such as the WTO. What is the economic rationale behind the latest global surge towards bilateralism? Unpacking this question may shed light on the probable gains to South Africa of an EU-South African free trade agreement.

2.2 The Advent of New Regionalism

The loss of momentum in multilateral trade liberalisation following the prolonged Uruguay GATT negotiations has sparked renewed interest in bilateral trade negotiations. Regional/ 'economic' integration amongst developing countries in the 1960s under the impetus of European integration, was not particularly successful and was superseded by a rejuvenation of multilateral tariff liberalisation in the 1980s. A second wave of regional/ 'economic' agreements has swept the international community in the 1990s, running parallel to multilateral agreements.

From the perspective of developing countries, such as South Africa, the return to regionalism in the 1990s differs from regionalism in the 1960s in three important respects. First, regional integration agreements in the 1960s occurred behind a veil of import-substitution industrialisation and inward-looking economic policies. Failure was inevitable due to the implementation of contradictory policies. On the contrary, new regionalism is embedded in an environment of outward orientation[11] and commitment to trade

[11] Singh (1994) argues that the economic concept "openness" is multidimensional, and may refer not only to a country's trade regime, but also to its financial and capital markets, technological, science, culture,

liberalisation among developing countries - objectives which are congruent to the tenets of regionalism and multilateralism.

As regards proposed EU-South African integration, South Africa's recent offer to GATT implies a commitment to significant tariff liberalisation. Past protectionist policies[12] are being eradicated in favour of supply-side measures aimed at fostering export growth[13]. Commitment to further trade liberalisation *beyond* GATT requirements will move South Africa's trade regime closer towards the outward-orientation of the EU, providing a suitable grounding for successful economic integration.

Second, attempts by developing countries at regional integration in the 1960s were pursued exclusively with other developing countries, whereas new regionalism is characterised by the emergence of regional/ 'economic' arrangements between developed and developing countries. This is central to the debate as to whether South Africa should rather be aligning itself to its Southern African Development Conference (SADC) neighbours[14] in a truly *regional* agreement, or whether it should pursue the EU's offer of an asymmetrical free trade agreement, thereby committing future trade growth towards the EU. Are these alignments mutually-exclusive, or is there room for parallel agreements?[15]

Third, the world's hegemonic power, the USA, has accepted and is itself pursuing the potential benefits of regional integration with the formation of the North American Free Trade Agreement (NAFTA) with Canada and Mexico (De Melo et al, 1994). This has had political economy effects in conferring a certain legitimacy to those countries pursuing parallel bilateral trading relations, whilst remaining committed to multilateral negotiations,

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education, and inward- and outward-migration policies. Consequently, a country can choose to be more 'open' in certain areas, such as trade, than in others, for instance, capital markets or foreign investment. Singh (1994) emphasises that there is no unique degree of 'openness' - optimum is dependent on the state of the world economy, and the level of development of the particular economy concerned, amongst others. "Openness" in this paper refers to the level of protection offered by a country's trade regime, and "outward-orientation" to the level of net trade (exports less imports) within the economy.

[12]Refer to Hirsch, A., 1993, Trade Policy for Industrial Growth in South Africa, Report submitted to the Industrial Strategy Project, (Draft)

[13]Refer to Department of Trade and Industry (1995).

[14]SADC countries include Angola, Botswana, Lesotho, Malawi, Mozambique, Nambia, Swaziland, Tanzania, Zambia, and Zimbabwe.

[15] Jenkins and Naudé (1995) indicate that as multiple trade deals are permissible by the GATT, membership of SACU or SADC does not preclude South Africa from entering into a FTA with the EU. Similarly, conclusion of an EU-South Africa FTA will not preclude South Africa from pursuing additional regional agreements, particularly with Southern African countries.

such as the WTO. Accordingly, South Africa's negotiations for a FTA with the EU are viewed as supplementing, rather than undermining, its recent GATT offer.

The rationale underlying the proposed EU-South African integration is economic. The objective is to create an appropriate trading regime that will stimulate trade and economic growth between South Africa and the EU. The success of the proposed FTA is predicated, and in fact depends on the outward-orientation of EU and South African trade policy.

However, the move by the EU to exclude up to 39% of South Africa's agricultural exports from preferential entry into the EU market is clearly aimed at protecting those 'sensitive' agricultural products covered by CAP. The FTA proposals, as amended, require the EU to remove duties on 7% of its trade with South Africa, whilst South Africa will be called on to remove duties on 37% of its EU trade (Business Day, 1996). The burden of tariff reduction will fall squarely on South Africa. Although tariff liberalisation does confer competitive dynamic benefits to an economy, an EU-South Africa FTA constructed in this way will not confer many static benefits to South Africa, and may be deleterious to South African industry. First, considerable exclusion of South Africa's exports to the EU limits the potential static gains from trade creation for South Africa. And second, complete tariff liberalisation in 'sensitive' industries, albeit phased in during the maximum period, may impede critical industrial restructuring.

Debate around the EU-South Africa FTA proposals rests on intuitive arguments of possible gains and benefits. A clearer understanding of both the static gains and losses and the potential dynamic gains of an 'economic' integration agreement, such as the proposed EU-South Africa FTA, may be obtained by a tailored review of the theory of regional integration.

2.3 Gains due to Regional/ 'Economic' Integration

When integration is formulated at either the free trade or customs union level, possible economic gains include:

- enhanced *allocative* efficiency resulting from increased specialisation in line with static comparative advantage;
- improved *productive* efficiency due to the employment of internal economies of scale[16] resulting from an increase in the size of the market;
- improved efficiency at a micro-level due to enhanced competition in domestic markets;
- dynamic economies of technological advance;
- external economies of scope[17] and agglomeration[18], and technological spill-overs between vertically-aligned industries;
- an enhanced investment climate;
- improved international bargaining position, particularly for developing economies aligned to stronger developed economies (El-Agraa, 1990).

Dynamic gains from improved productive efficiency, technological advances and an improved investment climate are certain to be important longer terms effects for South Africa of a free trade agreement with the EU. However, short-term effects should not be discarded. On the contrary, closer examination of the theoretical analysis of such static gains may shed light on the contentious issue of product exclusions in the negotiations.

2.3.1 Static Gains from Regional/ 'Economic' Integration

Initial economic analysis of regional integration focuses on the static gains accruing to member countries within a customs union, the assumption being that similar gains accrue to member countries within a free trade area. At first, customs unions were encouraged as they were thought to have encompassed a movement towards freer world trade. It was aknowledged that although customs unions would not maximise world welfare, it was

[16] Internal economies of scale refers to the cost-reducing relationship where unit costs decline as output within the firm increases (Ajam, 1994).

[17] Economies of scope refers to the situation where a group of products can be produced at lower cost by a single multiproduct firm, than by an assembly of more specialised firms producing a subset of the industry's products (Baumol and Lee, 1991).

[18] External economies of scale generally arise from technologically advances, and are attained by the resultant increase in productive activity, e.g. the use of automation in manufacturing production. Whereas external economies of scope derive from "positive and negative transactional relations" between firms. While economies of scale and scope are essentially *quantitative* in nature, economies of agglomeration introduce *qualitative* effects in that they refer to inter-firm co-operation, i.e. innovative horizontal relationships (e.g. skill and technology transmission) formed to solve common problems within industrial clusters, particularly among small-, medium- and micro-sized enterprises (Ajam, 1994, Prinsloo, 1996).

agreed starting from an initial protectionist scenario, a move towards customs unions did increase world welfare. Such was the rationale behind GATT article XXIV[19] which allows the formation of customs unions and free trade areas as specific exceptions to the principle of non-discrimination (El-Agraa, 1990).

Viner (1950 in Lipsey, 1960) questions such rationale, indicating that the formation of a customs union or a free trade area was not necessarily a *movement* towards freer world trade as it permits discriminatory trade liberalisation. At a static level gains to member countries and the rest of the world depend on the relative gains due to trade creation and the losses resulting from trade diversion or trade suppression (see Appendix 2).

Trade creation occurs when a member country substitutes products produced domestically prior to the creation of a customs union or free trade area with goods imported from the member country at a relatively lower cost.

Trade diversion and *trade suppression* take place when lower cost imports from the rest of the world are displaced by higher cost imports from the member country, or by higher cost domestic production, respectively. Net gains to regional integration are therefore an empirical question, determined by the relative magnitudes of trade creation, diversion and suppression.

Viner's analysis leads to the following conclusions:

- If neither the home country H nor the prospective integrating partner country P are producing a given commodity, but import it from the lowest-cost producer in the rest of the world W, regional/ 'economic' integration between H and P does not change the pattern of trade in the given commodity; both countries continue to import that particular commodity from W.

- If *either* H *or* P produce the given commodity inefficiently under tariff protection, ensuing integration will be trade-diverting, as trade is diverted away from the lowest-

[19]GATT Article XXIV permits the formation of regional integration agreements on the provision that "contracting parties recognise the desirability of increasing freedom of trade by the development, through voluntary agreements, of closer integration between the economies of...[partner]...countries....[The] purpose of a customs union or free trade area should be to facilitate trade between the constituent territories and not to raise barriers to the trade of other contracting parties with such territories" (GATT Article XXIV in El-Agraa, 1990:15).

cost producer in the rest of the world, W, toward the member country producing the commodity.

- When *both* countries are producing the given commodity inefficiently under tariff protection prior to integration, removal of tariff barriers will allow the lower-cost producer to capture the market, improving allocative and productive efficiency and leading to gains from trade creation. (Lipsey, 1960).

Consequently, Viner concludes that complementarity in production in the range of commodities produced inefficiently under tariff protection is likely to cause regional/ 'economic' integration to be trade-diverting, as trade is diverted away from the lowest-cost producer in the rest of the world. Similarly, trade creation is more likely to result when there is greater similarity in the range of commodities produced by the member countries and which are heavily protected by tariffs. In this case, trade creation will occur as these goods will now be sourced from the most efficient producer between the integrating economies.

Makower and Morton (1953, in Lipsey, 1960) clarify this result by defining *competitive economies* to be those with *similar* cost ratios, and *complementary economies* to be those with *dissimilar* costs ratios. Their analysis concludes that the gains from trade creation would be greater the more divergent the cost ratios of the member countries. That is, trade creation will increase, the greater complementarity there is in *comparative advantage* between the integrating states, where comparative advantage is defined by prevailing production cost ratios.

Viner's conclusions that a (net) trade creating integration is welfare-enhancing, but trade-diverting integration is welfare-reducing have been challenged on numerous grounds, but still remain the basis on which further analysis on integration is grounded and elucidated. The simplifying assumptions on which Viner's analysis is based - i.e. commodities are consumed in fixed proportions and constant costs in production - have severely limited its applicability.

Lipsey (1960) questions Viner's assertion that trade diversion is necessarily welfare-reducing. Viner's analysis implicitly assumes that commodities are consumed in some fixed proportion that is independent from a change in relative prices. That is, welfare effects from the consumption substitution between commodities resulting from a change in

relative prices are ruled out. Consequently, Viner's sole consideration of production effects leads to the conclusion that trade diversion necessarily lowers welfare.

However, as integration necessarily changes the relative prices, there is a substitution in consumption *between commodities* towards the relatively cheaper goods imported from the partner country, and away from the relatively more expensive goods imported from the rest of the world and produced domestically. Consequently, net gains depend on the relative magnitude of the opposing production and consumption effects.[20]

The distinction between production and consumption effects is itself unsatisfactory. The presumption that trade-diverting integration may still be welfare-enhancing due to the presence of positive consumption effects, is misleading as it is based on a model containing only two goods, one domestic and one import. Lipsey (1960) concludes that if the model is expanded to comprise three types of goods - domestic goods, imports from the partner country, and imports from the rest of the world, the move from non-preferential tariff protection towards bilateral integration would cause the *net* gain in welfare to be *a priori* indeterminate[21]. This leads back to the conclusion that the net gains from integration depend on empirical estimation.

A more adequate distinction is that between *inter-country substitution* and *inter-commodity* substitution. *Inter-country substitution* refers to shifts in production *locale* of a given commodity leading to trade creation and trade diversion effects in bilateral integration. *Inter-commodity substitution* occurs when a particular commodity is substituted for another due to a change in relative prices. Both these effects will cause changes in production and consumption.

Consideration of the three-good model gives rise to the following general conclusion: given a country's volume of trade, bilateral integration will more likely *raise* welfare the higher the proportion of initial trade with its partner country and the lower the proportion of trade with the rest of the world (Lipsey, 1960).

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[20] See Gehrels, F., 1956, Customs Union from a Single Country Viewpoint, Review of Economic Studies, Vol. 24, No. 63.

[21] See Lipsey (1960) for an explanation of the optimum relationship between the three types of commodities - foreign, imports from the union partner, and imports from the rest of the world.

Cooper and Massell (1965) raise a further critique of the Vinerian model of trade creation and trade diversion (see Appendix 3). Their critique presents a formidable attack on the relative merits of discriminatory trade liberalisation as opposed to *unilateral* tariff liberalisation. They suggest that 'trade diversion' is attributable to the discriminatory nature of tariff liberalisation, and can be avoided if a policy of unilateral tariff reduction is followed.

The Cooper-Massell critique eliminates the resource-allocation rationale for regional/ 'economic' integration. They argue that countries would be better off under unilateral tariff liberalisation. This argument is only valid if the partner country is not the lowest-cost supplier; otherwise it would be more beneficial to follow a policy of unilateral trade liberalisation. If the lowest-cost supplier is indeed the partner country, integration of some form is desirable, as it will yield net gains to both (all) member states.

Analysis so far has ignored the discrepancies between customs unions and FTAs within the ambit of regional/ 'economic' integration. This was intended as the theoretical underpinnings of analysis of free trade areas are based on that of customs union analysis. But in order to further analyse whether South Africa would gain from negotiating a free trade agreement with the EU, it is appropriate to focus more specifically on analysis of FTAs.

2.3.2 Static Gains resulting from the Formation of a FTA

De Melo, Panagariya and Rodrik (1994) analyse the static implications of trade diversion and trade creation for free trade areas, building on the traditional welfare analysis of customs unions. Rejecting the conventional notions of producer and consumer surpluses based on demand and supply analysis, the authors analyse the welfare implications of a free trade area between the home country and the potential partner country using general equilibrium import and export demand curves (see Appendix 4).

Their analysis concluded that the net gains of a FTA to the home country depend on:

- higher initial tariffs;
- lower post-FTA tariffs on extra-member countries, which reduces the likelihood of imports from these countries being diverted to member countries; and

- greater complementarity in import demands between the integrating states. This will lead to a larger divergence between the import demand curve and the export supply curve, increasing net trade creation gains.

De Melo et al (1994) note that at low per capita incomes economies of *different* factor resources are likely to be complementary, whereas at higher capita incomes economies of *similar* factor resources will be complementary. This arises due to the nature of specialisation at different stages of economic development.

At lower levels of industrialisation, economies are mainly dependent on the production and export of primary products marketed in conditions approximating perfect competition. Consequently, developing economies most suited to regional integration tend to be those with dissimilar factor endowments.

At higher levels of industrialisation, the prevalence of imperfect competition and product differentiation leads to a high degree of *intra-industry* trade between countries of similar factor endowments[22]. Therefore, at higher per capita incomes complementary economies most suited to regional integration tend to be those exhibiting similar factors of production.

Balassa (1962 in El-Agraa, 1985) argues that the autonomy of member countries in free trade areas to impose independent tariff policies leads to the deflection of trade, production and investment. Trade deflection occurs when imports from the lowest-cost producer outside the FTA, enter the free trade area via the member country with the lowest external tariff, and are then shipped tariff-exempt to member countries with higher external tariffs. Deflection of production and investment occur when the production of a particular commodity requires large amounts of raw materials imported from the lowest-cost supplier outside the FTA, but which are subject to tariffs.

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[22] When free trade analysis assumes the prevalence of internal economies of scale due to *decreasing* costs, traditional trade creation gains on the formation of a free trade area are augmented by cost reduction effects. These must be compared against welfare losses due to trade diversion and trade suppression in assessing net gains. Note that when there is high potential for trade-diverting integration, the formation of a free trade area is preferable to that of a customs union as the former allows member countries to individually lower their tariffs vis-à-vis the rest of the world, reducing both trade diversion and trade suppression effects.

Tariffs, as a second best instrument, distort the true comparative advantage in domestic production, leading to inefficient allocation of resources in a static sense. In a free trade area, differences in tariffs between member countries on a particular commodity exacerbate this effect. If deflection of trade, production or investment does occur, the free trade area then effectively becomes a customs union with the common external tariff equal to that of the lower tariff member country. However, in order to prevent this eventuality, most free trade areas adopt comprehensive rules of origin which explicitly specify the origin of commodities that are exempt from tariff imposition under the free trade area agreement (De La Torre and Kelly, 1993).

Rules of origin serve to discourage the use of the preferred country as an assemblage point for third countries trying to gain preferred access to the free trade area. Rules may be extremely complex and restrictive, acting as a legitimate non-tariff barrier in the free trade agreement (Cassim and Hirsch, 1994).

Although autonomous tariff policies of member countries in free trade areas may result in the unintended deflection of trade, production or investment, a clear benefit to such an integration agreement is the minimisation of trade diversion. The absence of a common external tariff policy allows a member country to unilaterally lower tariffs against the rest of the world, and replace relatively more expensive imports from the partner country with cheaper imports from the lowest-cost supplier in the rest of the world. This action itself has certain consequences as it lowers the value of concessions (economic rents) to the partner country. Clearly, trade diversion costs are also minimised the greater the proportion of intra-regional trade *prior* to integration, or when initial trade barriers are very high or extremely low, permitting little trade diversion to partner countries when integration is implemented.

The protracted success of the Uruguay Round of GATT to further multilateral trade liberalisation compared against the phenomenal rise of bilateral trade agreements, raises the debate of whether regional/ 'economic' integration opposes or is complementary to multilateralism in the present world economy. From the perspective of a small economy, unilateral trade liberalisation is often superior to regional integration as proved by Cooper and Massell (1965). However, the latter assume that there are zero tariffs levied by the partner country. Once the analysis is extended by introducing tariffs in the partner country, the question arises - can the home country boost its welfare more by unilateral trade liberalisation or by forming a free trade area?

Further analysis by De Melo et al (1993), which introduces tariffs levied by the partner country in addition to those in the home country, concludes that unilateral tariff reduction will still be preferred to free trade formation unless the partner country is willing to accept a sub-optimal position for political or strategic objectives (see Appendix 5).
A free trade area would be preferable to unilateral trade liberalisation if the home country could adequately compensate the partner country for the loss of welfare due to the formation of a free trade area. However, required compensation exceeds the gains from the free trade area (see Appendix 5). Therefore, the formation of a free trade area would be preferable to unilateral trade liberalisation only in the case where the partner country chooses to accept a suboptimal welfare position due to strategic or political reasons.

This analysis assumes that the potential integrating states only face tariff barriers between themselves. When tariffs prevail not only in the home country and in the potential partner country, but also in the lowest-cost producer in the rest of the world, then the formation of a free trade area between the home country and the potential partner country *may* be considered to be welfare-superior to unilateral trade liberalisation (see Appendix 5).

This scenario is particularly relevant if the world were to divide into protectionist trading blocs. An 'outside' country would be better off seeking entry to one of the blocs, than attempting unilateral tariff liberalisation. While this scenario is instructive, it does not alone provide sufficient justification for the preference of economic integration over unilateral tariff liberalisation in the present global economic environment. The international economy has not divided into fortressed trading blocs. On the contrary, it is characterised by outward-orientated regional integration amidst the continuation of multilateral trade liberalisation. Nevertheless, political economy illustrates that national agendas are fickle and may change over time. The question is therefore whether small developing countries are willing to join the drive to globalisation or be potentially marginalised?

This analysis allows insight into the surge of 'economic' integration agreements in recent years between developed and developing countries, such as the proposed EU-South Africa FTA. But what are the specific pressures that brought about such a dramatic change in the focus of what was previously 'regional' integration in the 1960s to 'economic' integration in the 1980s and 1990s?

2.3.3. The Rise of 'Economic' Integration between Developed and Developing Countries

An additional feature of new regionalism is the rise of economic integration between developed and developing economies. This is primarily due to:

- the rise of a triad of regional trading blocs - the European Union, NAFTA, and the Association of South East Asian Nations (ASEAN) economies - have led developing economies to seek economic alignment with developed economies in order to prevent economic marginalisation;

- smaller economies may increase their bargaining power by integrating with a larger partner;

- the protracted ability of the GATT, and its successor the World Trade Organisation (WTO) to reduce barriers to international trade via multilateral negotiation;

- slower economic growth in developed economies and policies of macroeconomic austerity have led the latter to reduce fiscal aid to developing countries, instead offering them concessional trade packages. Concessional trade packages are progressively being phased out in favour of regional agreements allowing developed countries greater market reciprocity with developing countries in an effort to expand trade. The highest growth in trade at present occurs between developed nations and developing countries. If present trends continue, the locus of growth in trade will shift to developing countries between 2005 and 2025, as these economies (particularly East Asian developing economies) are accounting for an escalating share of both global production and trade (Mistry, 1995).

The shift to regional/ 'economic' agreements between developed and developing countries cannot solely be explained by the move to global trading blocs. Why then has bilateral integration surged in recent years? Of greater concern in the negotiation of recent integration agreements is how dynamic gains affect the long-term growth prospects of member states, particularly those of developing countries.

This is not to say that negotiations should not tackle the issue of maximising possible short-term gains, and minimising losses or adjustment costs; merely that negotiators

should be aware of the potential contribution dynamic gains can make to long-term growth prospects, particularly in a developing country such as South Africa. The difficulty lies in negotiating a deal that is beneficial in the short-term, minimising adjustment costs due to accelerated tariff liberalisation, and which allows dynamic gains to be reaped in the longer term.

2.3.4 Potential Dynamic Gains due to Regional/ 'Economic' Integration

Dynamic gains refers to:

- internal economies of scale made possible by the increased size of the market, which allow firms previously operating below minimum efficiency level to operate efficiently at optimum capacity;
- external economies of scale - technological spill-over and agglomeration effects serve to lower general cost structures and enhance productive efficiency;
- the influence on the location and volume of net investment[23]; and
- enhanced economic efficiency resulting from increased competition due to reduced protection and increased economic certainty (De La Torre and Kelly, 1993, El-Agraa, 1985).

Although internal economies of scale may be considered to be a static gain if capital, labour and technology are assumed constant, they bear considerable potential for dynamic gains. Exploited due to the prevalence of larger markets resulting from regional/ 'economic' integration, economies of scale enable firms to reap internal benefits as unit production costs decline and productivity is enhanced. Firms previously operating at below minimum efficiency can expand output, enabling them to move down their cost curves (in static models), and their learning curves (in dynamic models).

Whilst most of these dynamic effects are intangible and long-term by nature, thus impossible to quantify, economies of scale can be analysed in orthodox economic terms. A clear failing of Vinerian analysis was that it assumed constant or increasing costs in production. Corden (1972) analyses whether the concepts of trade creation and trade divergence were still appropriate when *internal* economies of scale were taken into

[23] *Net* investment is defined as that investment which occurs *over and above* the replacement of worn-out capital equipment and/or plant. That is, *new* investment which serves to *expand* production.

account. Internal economies of scale confer a cost advantage to larger firms and are therefore consistent with an imperfectly competitive market structure, i.e. where the market is dominated by a few large firms.

This introduces the assumption of imperfect/ monopolistic competition into original integration models of customs union formation. Corden concludes that the incorporation of economies of scale into the analysis of the welfare effects of integration does not invalidate the traditional concepts of trade creation and trade diversion; it introduces the concepts of the *cost reduction* and *trade suppression* effects.

Cost reduction occurs when the home country experiences a gain in welfare due to domestic production expanding on the formation of a customs union or free trade area allowing a decline in average unit cost due to the exploitation of economies of scale.

Trade suppression takes place when imports from the lowest-cost producer are replaced by inefficient domestic producers on the formation of a customs union or free trade area in an attempt to exploit economies of scale (Corden, 1972, Krauss, 1972). (See Appendix 6.)

In consideration of further dynamic gains to integration, larger markets may also facilitate *external* economies of scale or industry spill-over effects. These are more likely in high-technology industries where technological knowledge and capabilities are inclined to be transferred between vertically-aligned industries. External economies of scale could also be achieved through greater regional co-operation in infrastructure - transportation and telecommunications networks - and in co-ordinated research and development ventures.

Significant dynamic gains can also be achieved by increased competition due to reduced protection. Even in an imperfect market structure, where internal economies of scale and product differentiation encourage the prevalence of monopolistic competition, intensified competition serves to enhance economic efficiency and prevents the abuse of market power by dominant economic agents. This will occur only when markets are perceived to be *perfectly contestable*.

Perfectly contestable markets are those where entry and exit into the market are costless for rival competitors. All producers must have access to the same technology, which may have fixed, but not sunk (unrecoverable) costs. This minimises any cost advantage that established market participants may have over potential market entrants (Helpman and

Krugman, 1985). Under contestability, potential market entrants in addition to actual market rivals provide competitive pressures in the market.

The benefits of perfect contestability include:

- lack of excessive (monopolistic) pricing, although internal economies of scale do not permit pricing behaviour where price equals marginal cost;
- lack of inefficiency or waste;
- the absence of cross-subsidy or predatory pricing; and
- pareto optimal pricing behaviour, i.e. where pricing is consistent with efficient allocation of resources in a situation that encompasses internal economies of scale (Baumol and Lee, 1991).

Contestable markets encourage corporate restructuring and industry rationalisation, in addition to continuous technological upgrading in an effort to maintain the competitive edge against potential rival competitors[24].

In the presence of internal economies of scale, increased trade opportunities due to regional' 'economic' integration raise the number of viable market entrants, increasing competitive pressures and improving allocative and productive efficiency. Contestability can therefore provide a more realistic approximation of market structure when internal economies of scale of present, than can perfect competition (Baumol and Lee, 1991).

Finally, the investment climate in member countries is likely to improve as regional integration serves to provide larger markets to potential investors. Investors also benefit due to increased investment opportunities. The profitability of technological innovation will increase as the average cost of research and development declines and economies of scale, scope, and agglomeration are facilitated. In addition, investment will prove more attractive as increased competition spurs economic efficiency, enforcing continual corporate restructuring and industry rationalisation in an effort to maintain competitive advantage. This will further increase the efficiency and profitability of investment opportunities.

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[24] The strict assumptions underlying perfectly contestable market theory force it to be a theoretical construct, untenable in realistic market structures. However, the theory does offer valuable policy insight. Economic inefficiencies often prevail in markets that are dominated by oligopolistic behaviour, i.e. uncompetitive pricing behaviour, restrictive trading agreements etc. Competition policy therefore plays a crucial role in monitoring and preventing abusive market behaviour by larger firms, and encouraging the entry and active participation of small- and medium-sized firms.

The investment-enhancement effect of regional/ 'economic' integration is not a tangible benefit that can be analysed *a priori*. A positive investment climate is dependent on a multitude of factors, some of which include political climate, monetary policy stance and the level of interest rates, fiscal stance and the level of the budget deficit and public debt, and exchange rate stability, among others.

Consequently, regional/ 'economic' arrangements are enhanced by a measure of *positive* integration with regard to harmonised policies and regulations - specifically, fiscal, monetary, exchange rate and competition policy. In particular, for a small developing country, such as South Africa, macroeconomic stability is an attractive potential outcome of an integration arrangement with a larger, more developed economy. Macroeconomic stability is conducive to an attractive investment climate - investors demand lower risk premiums, lowering the required return on marginal investments and lengthening their planning ranges.

The issues are complex and require the delicate balancing of short-term concerns against longer term benefits. Policy makers cannot afford to be myopic and simply concede to the demands of those interest groups affected by short-term losses - although these concerns must be realistically assessed. They must work towards a vision of long-term growth and sustainable economic development, particularly in developing countries such as South Africa. This requires that they be able to explain the link between integration and sustainable economic growth and development to be able to justify short-term adjustment costs.

2.4 Growth effects of Regional/ 'Economic' Integration

Why is growth theory applicable to regional integration and trade liberalisation? First, growth per capita implicitly assumes an accumulation of capital - whether it be investment in physical capital or human knowledge capital. Consequently, international trade impacts on the medium- to long-term growth prospects of an economy by influencing the stock and rate of accumulation of physical and human capital, in addition to technological progress. Bilateral trade agreements aim to further trade between integrating states and, if appropriately structured, may serve to improve physical and human capital accumulation, and the appropriation of technological expertise.

Neoclassical growth theory, based on the Solow model (see Appendix 7), facilitates understanding of how technological, physical and human capital accumulation impact on the growth of output. The key contribution of neoclassical growth theory to the analysis of regional/ 'economic' integration is the significance it attaches to technological progress and increased labour productivity in sustained economic growth.

Such analysis highlights the importance of capital accumulation - physical and human - and technological progress in projecting developing economies, such as South Africa, onto higher growth trajectories. However, it is argued that the Solow model presents a simplistic view of reality, as it assumes key variables, in particular technological and human capital accumulation, to be exogenous. Analysis of economic integration should rather consider how the predictions of new growth theory endogenise these variables.

The inability of exogenous growth models to explain divergent technological progress, leading to variations in per capita incomes and national growth rates, between nations emphasises the need for technology to be endogenised in growth modelling (Romer, 1994). The accumulation of technological capability is fundamental to competitive advantage in international trade. Competitive advantage is increasingly dependent on value added to the production process - in which technology and factor productivity play an inestimable role - rather than by the given factor endowment of any country as predicated by conventional trade theory.

The introduction of endogenous technological accumulation assumes the incorporation of imperfect competition in product markets. In the Schumpeterian sense, firms need incentives - albeit in the form of oligopolistic market returns - to undertake continual investment in technological upgrading[25].

Oligopolistic trade models permit the distinction of *inter-industry* and *intra-industry* trade. *Inter-industry* trade transpires due to comparative advantage created by differing resource endowments, whereas *intra-industry* trade (i.e. two-way trade in specific commodities) occurs due to the effects of internal economies of scale and oligopolistic competition (Krugman, 1989). Technological accumulation is central to competitive advantage,

[25] According to Schumpeter (1987 in Chang, 1994) technological innovation requires long-term planning and asset-specific investments, which are only possible in a monopolistic/ oligopolistic environment.

specifically in intra-industry trade[26], which is based on value-added to the production process, rather than on comparative advantage in raw materials.

Regional/ 'economic' integration and trade liberalisation *may* lead to greater technological accumulation, rising factor productivity and hence higher rates of economic growth. Integration into a wider world market facilitates access to a broader pool of technological knowledge, as well as a larger customer base. Trade often encourages technological development due to the marketing efforts of foreign exporters and importers, through the importation of capital goods and the gradual imitation of technology embodied in such imports, and through technological spill-overs in research and development (Grossman and Helpman, 1994). Regional/ 'economic' integration is also conducive to a more attractive investment climate as consumer markets widen, and may facilitate greater accumulation of human capital resulting from spill-over effects or specific agreements on training and technological co-operation between member countries.

This is not to say that strategic trade policies should be disregarded in favour of complete free trade. On the contrary, prudent protectionist policies may allow key industries to 'catch up' to their foreign competitors, before fully exposing them to international competition[27]. This is a key factor for consideration in the negotiation of integration agreements between developed and developing countries.
The application of endogenous growth theory to regional integration agreements highlights the fact that technological progress, in addition to the accumulation of physical and human capital, in favour of completely free trade are key determinants of accelerating economic growth. However, integration itself is not sufficient to enhance these processes. Integration agreements between developed and developing countries need to recognise the

[26] Krugman (1983) augments the theory of intra-industry trade, introducing dynamic competitive advantage into theoretical analysis. The theory of technological competition complements the theory of intra-industry trade by emphasising the crucial role of research and development (R&D) in maintaining competitive advantage on the global market. Of particular note is the analytical presumption that firms (domestic and foreign) compete in a technological manner. That is, increased investment acts to lower production costs and/ or develop new products. This means that the level of R&D investment by each firm determines that particular firm's position in later competition in the actual product market.
[27] Krugman (1989) suggests that the theory of technological competition in intra-industry trade provides a certain rationale for strategic trade policy and selective protection. Selective protection afforded to the domestic firms to induce higher levels of R&D may allow them to improve their relative technological position, increasing market share in the domestic and export markets. This rationale must be measured against the possible of abuse of protection, guarding the inefficiencies of powerful interest lobbies. This introduces the argument for 'conditional' protection, i.e. protection that is conditional on productivity improvements and performance in the export market. However, this strategy brings its own problems - for instance, on what basis does government select firms for such 'hard targeting' (Joffe et al, 1995)?

importance of technological and human capital accumulation by building *positive* elements of integration in addition to elements of tariff liberalisation. These should include institutions or arrangments dedicated to upgrading educational and technological capabilities of less developed countries. It is also important to ensure that developing countries gain expertise in management as well as physical and social infrastructure[28].

The link between regional/ 'economic' integration and long-term economic growth implies that integration agreements, such as the proposed EU-South Africa FTA, may bear certain implications for long-term economic growth prospects. The discussion is no longer merely focused on short-term gains or losses, but broadens to include longer term political and economic strategic benefits of bilateral trade negotiations.

[28] Stern (1991) argues that the lack of managerial capabilities and appropriate infrastructure in developing countries goes some way to explaining why scarce capital may be unproductive in these economies.

CHAPTER THREE

An economic assessment of the proposed EU-South Africa FTA

A tailored review of regional integration theory provides the necessary analytical tools to assess the merits and costs of the proposed EU-South Africa FTA. Theoretical insight facilitates probing the question, '*Will South Africa benefit from a free trade agreement with the EU*?'

Economic assessment must consider both short-term benefits and costs in addition to longer term dynamic gains. Debate and analysis have focused on whether an EU-South Africa FTA would be beneficial for South Africa in the short-term. Key political interest groups have raised concerns of significant adjustment costs in industrial restructuring, and minimal trade gains due to proposed exclusions of certain agricultural products from the agreement. This has contributed to contentious debate and the ensuing delay in negotiations.

3.1 Gains to South Africa from the proposed EU-South Africa FTA - Theory Applied to Reality

Against this backdrop, what insights does theoretical understanding offer to economic assessment of the proposed EU-South Africa FTA?

3.1.1 The Vinerian Model and its Critiques

At a static level, the Vinerian analysis of trade creation and trade diversion clarifies the conditions under which short-terms gains and losses will prevail. Although conditions in reality do not approximate the rigid assumptions presumed in the Vinerian model, the latter does provide an initial framework with which to analyse static effects of 'economic' integration between South Africa and the EU. Partner countries will clearly benefit if they

are able to maximise trade creation and minimise trade diversion effects. This is more likely to occur if the member countries are *complementary* (defined by dissimilar comparative advantage) rather than *competitive* economies trade (defined by *similar* comparative advantage).

This conclusion is central to the debate on whether South Africa should be focusing its efforts on its immediate regional neighbours within SADC, or aligning itself with a distant industrialised state such as the EU. Many attempts at African integration have been less than successful due to ignorance of the underlying economics of regional integration. This does not detract from the validity of arguments *for* Southern African integration. It merely emphasises the fact that South Africa should attempt regional/ 'economic' integration with complementary rather than competitive economies[29]. In addition, South Africa needs to take account of the possible implications of integration with the EU for other countries in SACU[30].

In addition, Viner's analysis concludes that any integration agreement is most likely to be trade-diverting if the majority of traded products are solely produced by *either* partner country inefficiently under tariff protection. Integration will lead to trade being diverted away from the lowest-cost producer in the rest of the world toward the inefficient partner country.

Based on this premise alone, it seems unlikely that the EU and South Africa would form a net trade-diverting integration agreement; the EU has low levels of tariff protection, and South Africa is negotiating the FTA concomitant to multilateral tariff reduction. In addition, there are few traded products which are produced solely by either the EU or South Africa inefficiently under tariff protection. Those traded products which are heavily

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[29] The theoretical rationale for this supposition is based on Makower and Morton (1953 in Lipsey, 1960), who conclude that the gains from trade creation on integration would be greater the more divergent the production cost ratios of the integrating states. That is, trade creation gains would increase the greater the complementarity in comparative advantage between the integrating states, where comparative advantage is defined by prevailing production cost ratios.

[30] It is important to note that bilateral agreements are not necessarily compatible with individual countries within a customs union. An EU-South Africa FTA will have definite implications for the other member countries of SACU; a complexity which South African trade negotiators will have to bear in mind. It is unnecessary that a FTA with the EU be concluded at the SACU level, as the remaining SACU countries are members of the Lomé Agreement and have preferential access to the EU market, but the structure of a FTA with the EU needs to consider the resulting implications for SACU countries. Tariff reductions resulting from the FTA will severely reduce the revenue from customs duties in the SACU revenue pool - an important source of revenue for SACU countries (Business Day, 1996).

protected under South African tariffs, for example consumer electronics and motor vehicles, are more efficiently produced by the EU. On these grounds there is greater probability for trade creation rather than trade diversion effects under the proposed EU-South Africa FTA.

However, trade creation gains to South Africa will be minimised if negotiations continue to exclude 39% of South Africa's agricultural exports to the EU. Potential for expansion in agriculture and related processing[31] industries does exist, but depends on access to new markets and greater access top existing markets (Stevens and Kennan, 1995). If the EU-South Africa FTA is structured with exclusions as tabled, short-term trade creation gains will be biased *in favour* of the EU, as the majority of South African exports to the EU will fall *outside* the agreement.

The conclusions resulting from Lipsey's critique of the Vinerian model, which extends analysis to a three-good model, re-inforces the theoretical supposition that the proposed EU-South Africa FTA is likely to result in certain static gains for South Africa, providing that it is appropriately structured. The potential for static gains rests on the fact that the EU is by far South Africa's predominant trading bloc, there is a high degree of intra-regional trade *prior* to integration. However, EU-South African trading links may be ascribed more to historical and cultural associations, than to comparative advantage, defined by prevailing production costs ratios. Consequently, the theoretical presumption that a high proportion of intra-regional trade *prior* to integration allows greater gains due to trade creation does not necessarily apply to the proposed EU-South Africa FTA in practice.

In addition, the presumption in favour of gains from trade creation assumes that the agreement includes 'substantially all' trade between the two states[32]. It does not allow for the exclusion of the majority of South Africa's agricultural exports to the EU. Retention of proposed exclusions will cause inter-country and inter-commodity substitution in favour of cheaper EU exports and away from relatively more expensive domestic goods, particularly manufactures, while those agricultural products comprising South Africa's comparative advantage are excluded from the agreement. At a static level, such

[31] See Hanival (1996), and Stevens and Kennan (1995).
[32] The EU mandate proposes that the FTA allow for removal of duties from 90% of both EU and South African imports (Business Day, 1996).

integration is prohibitively expensive for South Africa in terms of employment losses and other adjustment costs resulting from accelerated tariff liberalisation.

This raises the question whether South Africa should be pursuing bilateral trade negotiations ahead of multilateral efforts. What are the opportunity costs of concentrating expertise and effort in such discriminatory trade agreements? Would it be preferable for South Africa to rather focus on multilateral trade negotiations?

The Cooper-Massell critique considers whether unilateral tariff reduction would be preferable to integration, specifically the formation of a customs union. Analysis indicates that benefits from customs union (or FTA) integration would be greater than those of unilateral tariff reduction if the integrating partner were the lowest-cost supplier of those goods imported.

Although South Africa's largest trading *bloc* is the EU, a direct consequence of historical and political links, the USA is South Africa's largest trading *partner* - in 1992, South Africa sourced 15.5% of its total imports from the USA, and exported 7.2% of total exports to the USA (Hirsch, 1994). In addition, the Asian market is of increasing significance to South Africa. In the period 1990-1994 South Africa's trade with China increased by 226%. With an expected average growth rate of between 8% and 10% per annum to the year 2000, China will become a market of greater significance for South African trade (Kuper, 1996).

The importance of these trends are noted by the Department of Trade and Industry's Global Strategy Project (Cassim and Kuper, 1996). The study emphasises whilst South Africa needs to "expand or at least maintain market share in its traditional markets...[it] also critically needs to increase its exports into new growth markets" (Cassim and Kuper, 1996:56). Consequently, whilst Europe is South Africa's most important market in terms of the number of product categories and high value-added manufacturers, South Africa's annual export growth between 1992-1994 was extremely high in Central America (106.64%), Southern Africa (98%), and South America (40%), albeit due to low initial bases. Export growth to East Asia averaged at 13.48% per annum in this period, whilst growth to ASEAN countries rose by 70% and that to Australia and New Zealand by 40.44% (Cassim and Kuper, 1996:29).

These export statistics indicate that South Africa is experiencing dramatic export growth in those markets where its export base is low, and steady export growth in those markets exhibiting high annual growth rates[33]. However, high-growth markets are not necessarily those with substantial purchasing power or import market share. Consequently, analysis indicates that South Africa should not merely focus on high-growth markets to the detriment of its traditional industrial markets, particularly the EU and USA, which still hold much of the world's import market share (Cassim and Kuper, 1996).

The changing dynamics of South African trade suggest that although EU-South African trade is significant due to historical links, the EU is not necessarily the lowest-cost supplier of those goods which are presently sourced in the EU, nor a market that is exhibiting high levels of growth. On this basis, estimation of gains from trade creation and losses from trade diversion would require detailed comparative cost analysis of South Africa's imports.

Moreover, South African trade negotiators need to consider the opportunity costs of an EU-South Africa FTA that might bias future trade expansion towards the EU, and against the increasingly significant USA and Asian markets[34]. Considerable expertise and cost have been invested in trade negotiations with the EU - resources that might have been more efficiently utilised in multilateral trade negotiations.

The above analysis holds a certain intuitive appeal, but does not alone provide sufficient justification to conclude or refute whether integration is definitely preferable to unilateral tariff reduction under multilateral trade negotiations. Further analysis into the relative benefits of 'economic' integration in the form of free trade areas is necessary to assess whether it would be in South Africa's interest to conclude a FTA with the EU, rather han concentrating its efforts and expertise in multilateral negotiations under the WTO.

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[33] Cassim and Kuper (1996:11) note that "there is often a strong correlation between market diversification and product diversification....[This implies that] South Africa's entry into non-traditional Asia-Pacific, Latin American or African markets could be accompanied by a more diversified export portfolio".

[34] See Cassim and Kuper (1996), Chapter 3.

3.1.2 Gains from a FTA

The trend towards FTAs rather than customs unions in regional/ 'economic' integration confers greater autonomy on integrating states to impose independent tariff policies. This serves to further minimise trade diversion, as integrating states are able to unilaterally lower their tariff barriers towards the rest of the world, sourcing imports at the lowest cost. Such autonomy in external trade policy is borne at the cost of possible deflection of trade, production and investment. These effects are mitigated by the imposition of comprehensive rules of origin, which explicitly specify the origin of tariff-exempt products.

The proposed EU-South Africa FTA would most certainly be subject to rules of origin to prevent South Africa becoming a mere assemblage location for intermediate products from third party countries[35]. Unless the FTA includes specific clauses on defined rules of origin, third party countries will by-pass EU tariff duties by simply routing their products through South Africa. If there is no value added to the production process in South Africa, trade creation will not occur. Similarly, without rules of origin in place, a low-cost producer, for instance, Chinese clothing producers[36], could circumvent higher South African duties on clothing imports by routing the goods via the EU into South Africa. However, South Africa must be careful that the EU does not attempt to introduce further non-tariff barriers in the form of complex rules of origins.

Further analysis by De Melo et al (see Appendix 4) facilitates the theoretical presumption that South Africa should be able to form a FTA with the EU with little trade diversion occurring. High average tariff barriers on South Africa's side (prior to GATT reductions), and low average EU product tariffs (excluding those agricultural products covered by CAP) will reduce trade diversion on integration. However, South Africa will face a trade-off between further unilateral tariff reduction, beyond its GATT commitment, reducing any trade diversion that does occur from lower-cost suppliers outside the FTA, and those adjustment costs which may result from accelerated tariff liberalisation.

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[35] It is important to note that specified rules of origin in an EU-South Africa FTA should not discriminate against goods traded within the South African Customs Union (SACU).

[36] See Altman (1993) for a comparison of international production and labour costs.

So far analysis has assumed that only South Africa levies tariffs on goods traded with the EU. If the more realistic assumption of both the EU and South Africa levying tariffs is adopted, in theory, the formation of a fully inclusive EU-South Africa FTA would only be preferred to unilateral tariff reduction where the EU chooses to accept a suboptimal welfare position due to strategic or political reasons (refer to Appendix 5). This points to the EU's rationale for initiating the offer of a FTA with South Africa.

Initially, the EU offer of a free trade agreement with South Africa was made with the specific intention of normalising trading relations with the new political democracy. The proposed EU-South Africa FTA was extended as a specific economic instrument to expand trade between the two states, acting as a spur to economic growth in South Africa.

Under this scenario, and with the general acceptance that multilateral trade negotiations are often a protracted event, it seems quite plausible that the EU would accept a suboptimal welfare position both for altruistic reasons and to normalise trading relations between the two states. However, the proposed list of exclusions indicates a hesitancy on the part of the EU to deliver on its initial offer. The present stance of the EU suggests that it is prepared for hard bargaining when negotiating a FTA with South Africa.

This scenario assumes that only the EU and South Africa levy tariffs. When tariffs are assumed to prevail not only in the EU and South Africa, but also in the rest of the world, the formation of an EU-South Africa FTA *could* possibly welfare-improving for both states (see Appendix 5). Conclusive arguments would again depend on empirical estimation of trade creation and trade diversion.

The above analysis serves to raise further questions. Should South Africa be building a series of bilateral agreements with its trading partners, locking into both major global trading blocs and fostering regional ties with its Southern African neighbours, or should it be concentrating its efforts in a neutral manner on WTO negotiations? Can South Africa afford to spurn the EU's offer of a FTA, if further negotiations over intended exclusions yield a more beneficial deal for South Africa?

These questions remain unanswered and subject to considerable debate. The proposed FTA between the EU and South Africa, and partial access to the Lomé Convention comprise a two-tiered offer on political, economic and trade co-operation that is currently being negotiated by both member countries. These negotiations are subject to much

controversy. Both member countries are bargaining to maximise the benefits and minimise the costs to themselves. But, is this necessarily a zero sum game? What are the actual costs and benefits ?

3.2 Empirical Analysis of Gains to South Africa from the proposed FTA

Empirical analysis of potential static gains resulting from the proposed EU-South Africa FTA is complex. It requires quantification of possible gains from trade creation and cost reduction effects, and losses from trade diversion and trade suppression effects. Such analysis is heavily dependent on data, for instance import demand and export supply elasticities, which are not readily available. Available studies reviewed do not attempt to tackle these questions, but concentrate on detailed descriptive analysis of possible *static* gains to South Africa from the proposed EU-South Africa FTA. This requires closer examination of the existing trade patterns between the two countries

3.2.1 Analysis of EU-South African Trade Patterns

Stevens and Kennan (1995) provide a detailed static analysis of EU-South African trade, facilitating a clearer understanding about the potential short-term implications of the proposed EU-South Africa FTA for both member countries. The study focuses on a select group of products that are important to trade negotiations between the EU and South Africa as they are traded in significant volumes and face substantial trade barriers in either one or both partner countries. Consequently, the majority of South Africa's traded products are excluded as they enter the EU at modest tariff barriers prescribed by the EU's Generalised System of Preferences (GSP).

GSP status forms the lowest common denominator of the EU's pyramid of trade preferences. All major countries manage their trading relations under GSP systems under a derogation from GATT. The EU offers GSP status to most developing countries, at the base of its hierarchy of trade preferences.

3.2.1.1 *GSP in Detail*

The Lomé Convention forms the apex of the EU's 'pyramid of privilege'. As stated, the Lomé Convention, being the EU's premier trade preference agreement, confers a liberal range of trade concessions and non-trade assistance measures, on a non-reciprocal basis, to the 69 countries of the ACP group. Next on the hierarchy are the 'Super GSP states'. Super GSP trade preferences are granted to those countries defined by the United Nations as least developed, and certain Latin American states on the same basis as Lomé, but over a narrower product range. The penultimate band accords trade preferences to Mediterranean and East European states with particular limitations on 'sensitive' products (grape, citrus and horticultural products covered by CAP) and certain quotas on traditional exports. The base of the trade preference pyramid comprises the remaining less developed countries, including the ASEANs, those Latin American countries not accorded Super GSP status, South Asia, and South Africa.

The EU's hierarchy of trade preferences is congruent with its objective of aiding the development of least developed countries (LDCs), concentrating assistance on the poorest countries. Liberal trade concessions to such countries with low per capita GDP concentrate on their traditional exports, and therefore provide no threat to EU industries. Accordingly, the EU grants progressively less liberal preferences to countries with higher per capita GDP, as there is more potential for conflict with domestic production. The glaring exceptions are those countries covered by bilateral agreements. They are often richer in terms of per capita income than GSP countries, but are treated more favourably in their trading relations with the EU (Select Committee on the European Communities, 1993).

Without access to the Lomé Convention or more appropriately, a reciprocal trading agreement, mere GSP status confers marginal benefits to South Africa. In fact, as most of South Africa's competitors retain greater access to the EU market, South Africa will be prejudiced in its trading relations with Europe unless a supplementary trade accord is negotiated.

3.2.1.2 *South African Exports to the EU*

A detailed description of current trade patterns between the EU and South Africa forms the basis of analysis of the proposed FTA. Stevens and Kennan (1995) undertake a static analysis of the key products traded between the two countries.

In consideration of South Africa's exports to the EU, Stevens and Kennan select key export products by value (inclusive of preferential tariffs). Those products that enter the EU under an existing or post-GATT tariff of 5% or less were eliminated. The remaining 45 items (at the 8-digit level on the Harmonised System [HS]) are central to the FTA negotiations because they are important (in value) to EU-South African trade, and currently face substantial trade barriers.

There is undoubtedly a clear agricultural bias in South African exports to the EU (See Appendix 8, Table 5). Deciduous fruits and vine products are of particular importance in traded value. Citrus fruits are also notable, but their traded value is lower. Significant industrial products include phosphoric acid and metals, and policy-relevant manufactures feature clothing, televisions, and plastic products.

A dynamic perspective reveals significant differences in current value change of the 45 policy-relevant items. Metals, fish and deciduous fruit (apples and prepared/preserved pears) have declined in current value between 1988 to 1993, whereas fresh grapes, plums, pears, exotic citrus fruit, wine, preserved apricots, trousers, plastic sacks and silicon hold potential for considerable growth (Stevens and Kennan, 1995).

The definite agricultural bias in South Africa's current exports to the EU does present cause for EU concern in the negotiation of a FTA. Many of these products, specifically deciduous fruits and vegetables, fall into the category of 'sensitive' products covered by CAP. The Mediterranean bloc of the EU (France, Portugal, Greece and Italy) are particularly concerned about the flooding of South African deciduous fruit and vegetables on the EU market, jeopardising their domestic agricultural sectors.

Presently, these 45 policy relevant products all face bound MFN (Most Favoured Nation) tariffs in excess of 5%. For 18 of the products the bound rate exceeds 10%. This means that those EU trading partners which enjoy better than MFN status possess an added

advantage over those with only MFN market access. South Africa possesses better than MFN access for 11 of the policy relevant items. These products are conferred with GSP status, the lowest trade preference accorded by the EU. In fact, the concession given is negligible as the applicable rates have been reduced to between 70% to 85% of the MFN rates for eight items (these fall into the 'sensitive' and 'less-sensitive' categories within GSP), whilst only three items enjoy duty-free access (Stevens and Kennan, 1995).

Concern rests not with the *absolute* level of tariff barriers which South African products face, but the *relative* tariff level when compared to market competitors. Stevens and Kennan (1995) identify that for 26 of the policy relevant items, South Africa's competitors all possess more favourable access to the EU market. This means that South Africa possesses an unfair disadvantage against other competitors for its exports to the EU market. A supplementary trade agreement, such as a FTA, is necessary to ensure at least equal competitive advantage in the EU market.

The negotiating mandate conferred to EU negotiators in March 1996 effectively excludes many of the sensitive agricultural products covered by CAP, as they are the centre of controversy in the EU agricultural lobby. The list of excluded products ranges from cut flowers to apples, lemons, pears, fruit juice, fresh oranges, melons, canned fruit, and grape juice. An attendant list (beef, poultry, sugar maize, sorghum, butter, powdered skim milk and alcohol) is signalled to come into effect if South Africa starts exporting these goods (Business Day, 1996). Products excluded from the FTA comprise as much as 39% of South Africa's agricultural exports to the EU. This is contrary to the GATT ruling permitting a FTA to be formed only if it covers *substantially all* trade between the partner countries.

Stevens and Kennan (1995) question the validity of fears that increased South African exports will adversely affect EU agriculture to any great extent. Analysis of intra-EU trade for the 45 policy relevant products revealed limited competition at the aggregate level. However, certain individual countries, specifically Greece, Spain, Portugal, the Netherlands, and Belgium/ Luxembourg compete with South Africa on products that account for around 1% of their intra-EU exports (see Appendix 8, Table 6). Greece is likely to be most affected by an EU-South Africa FTA as it competes with South Africa on six policy-relevant items, which form 3.25% of its intra-EU trade.

3.2.1.3 *Will there be a Change in the Composition of South African Exports to the EU in the Medium-Term?*

The critical policy question is whether there is sufficient scope for changes in the composition of South African exports to the EU over the short- to medium-term. There is debate as to whether South Africa has latent export potential on other products of competitive interest for the EU in the short-term due to its political and economic isolation in the apartheid years. However, a comparison between South African exports to third markets and those to the EU reveals a marked similarity in product coverage. Consequently, Stevens and Kennan (1995) conclude that South Africa has no immediate capacity for export expansion in other products sensitive to EU producers.

However, there is certainly potential for a change in South African exports to the EU in certain sectors[37] in the medium-term as the economy restructures and improves its manufacturing performance. The South African offer at the Uruguay Round of GATT indicates its commitment to tariff liberalisation, improving agricultural and industrial competitiveness. Past protectionist policies have distorted economic potential, facilitating economic stagnation.

Manufacturing export performance is poor, concentrated in primary or lightly beneficiated products; productivity is low and has been declining over recent years, as has investment (Joffe et al, 1995). In addition, poor export performance acts as a major constraint to growth for the South African economy. A high degree of dependence on imported capital and intermediate goods requires improved export performance to pay for the rise in imports as the economy expands. This avoids undue pressure on the balance of payments, and reduces the need for capital inflows to finance a current account deficit, (i.e. imports in excess of exports).

In the short-term, balance of payments constraints will necessitate that primary and lightly beneficiated products form the focus of labour-intensive export activities until industries

[37] Labour-intensive industries that indicate potential for improved competitiveness and export performance in the medium-term once sufficient restructuring has occurred include the pulp and paper, footwear, clothing (particularly in the Western Cape, and Kwazulu-Natal), motor vehicle component, fruit processing and canning, and tourism industries (Black, 1995, Hanival, 1996, October, 1996, Prinsloo, 1996, Stevens and Kennan, 1995).

become competitive in higher value-added and more complex products (Department of Trade and Industry, 1995).

However, South Africa's future competitive advantage cannot be found in the primary products which result from its given endowment of natural resources. Economic growth and sustainable development require the accumulation of human and physical capital, in addition to the building of technological capabilities. Investment, particularly in human capital and the national skills base, will foster dynamic competitive advantage and increase the economy's labour absorptive capacity. Employment generation and the reduction of income disparity are central concerns for a sustainable growth strategy in South Africa (Joffe et al, 1995).

Consequently, industrial strategy is moving towards a long-term vision of guiding industrial development 'up the value chain'. That is, enabling industry to focus on the production of higher value-added products, enhancing a high-level of international competitiveness. This will generate sustainable skilled, high wage employment. Additional 'supply-side' policies will target human resource development, training and work organisation, technological enhancement, improvement of productivity, and appropriate investment incentives designed to attract new investment and to upgrade physical infrastructure (Joffe et al, 1995, Department of Trade and Industry, 1995).

The need to revive industrial growth and improve performance in the manufacturing sector is critical for improved South African economic prospects. Improved economic growth is essential to increase available resources for redistribution to combat poverty and income inequality. Consequently, a growing economy is a prerequisite for a successful transition to democracy. Concern for political stability and the need for socio-economic delivery to a growing population places increasing pressure on industrial restructuring. This requires the implementation of an effective industrial strategy that is congruent with broader macroeconomic reform and facilitates substantial job creation.

Medium-term restructuring of the economy will see a change in the composition of South Africa's exports to the EU as performance in the manufacturing sector improves, and the importance of the primary agriculture sector declines. However, economic restructuring is not a straightforward process. External influences, in particular the EU-South Africa FTA, may inhibit or complement socio-economic reform in South Africa. Here, the outcome is dependent on the resulting structure of the EU-South Africa FTA and manner

in which it is implemented. The question is therefore, whether the EU-South Africa FTA in its proposed form will inhibit or support the medium-term restructuring of the South African economy?

3.2.1.4 *Can the proposed EU-South Africa FTA Support Medium-Term Restructuring of the South African Economy?*

It is within this context that South African trade negotiators need to consider whether the proposed EU-South Africa FTA is able to complement domestic macroeconomic, industrial and trade reform aimed at the medium-term restructuring of the South African economy. Specifically, negotiation of a FTA with the EU must be sensitive to the need for substantial job creation within the economy, and seek to enhance, rather than undermine, labour market reforms aimed at expanding labour-intensive exports.

In fact, consideration of employment and labour market concerns in industrial restructuring and broader macroeconomic reform are critical to the effective restructuring the South African economy in the medium-term.

In the past, substantial job creation has been constrained by the reluctance of the private sector to increase domestic investment, and the unwillingness of labour to accept lower real wages in less-skilled, labour-intensive sectors. Labour has refused to move on its position regarding minimum wages for fear of jeopardising the lot of those currently employed. However, high and rising unemployment - at present around 30% of the economically active labour force - has elevated employment concerns to the forefront of economic policy debate (Bradford, 1995).

Labour market reforms cannot alone provide the impetus for employment generation. South Africa must build a long-term vision that allows for labour-absorbing economic growth. The recently published report by the Labour Market Commission recommends a three-tiered approach to labour-absorbing growth. First, macroeconomic, industrial and trade policies must seek to *actively promote* employment creation. Second, labour market reforms must encourage labour market flexibility in a manner that ensures security. Here the Commission distinguishes between employment, wage and work process flexibility. It argues that certain forms of flexibility, particularly work process flexibility - changing

work tasks, times and practices - may be valued by workers, but more often flexibility is associated with declining labour market, employment, job, income and representation security.

Work process flexibility may be encouraged and achieved by consensus bargaining. Bargaining arrangements between employers and workers, if strengthened, will facilitate a balance of power within the labour market. These institutions should then seek consensus on the appropriate mix between flexibility and security in the labour market that is mutually beneficial to both employers and employees.

Third, labour-absorbing growth will be promoted by the co-ordination of labour market, macroeconomic, trade and industrial policies. Government, business and labour must recognise policy trade-offs, and seek the best possible integrated policy mix that will maximise economic growth and employment generation. To this effect, the Commission recommends the formation of a national Accord for Employment and Growth that will facilitate a tripartite alliance between government, business and labour, enabling consensus on trade-offs - for instance, negotiated wage moderation will reduce 'wage-push' inflation - that will facilitate labour-absorbing growth (Labour Market Commission, 1996).

Labour market reforms, together with trade and industrial policies, link microeconomic strategies to broader macroeconomic reform. The EU-South Africa FTA may *support* medium-term restructuring of the South African economy, if it is structured and implemented in a manner which complements labour market reforms and industrial restructuring strategies, aimed at improving productivity in labour-intensive manufacturing export sectors.

3.2.1.5 *What Implications do Labour Market Reforms have for Industrial Restructuring, and the proposed EU-South Africa FTA?*

South African trade negotiators need to question what implications the call for labour-absorbing economic growth has for industrial restructuring strategies, and therefore for the appropriate structure and implementation of the proposed EU-South Africa FTA.

Specifically, negotiations need to consider how the proposed EU-South Africa FTA should be structured in order to *support* labour-absorbing growth in South Africa by enhancing the expansion of labour-intensive exports. A focus on labour-intensive exports in the short- to medium-term will facilitate economic restructuring by:

- re-orientating South Africa industry towards the export market - this will encourage firms to improve productivity levels, gaining competitive advantage in the international market;
- increasing labour-absorption in the manufacturing sector, providing a kick-start to employment creation in the South African economy.

In the past, industrial policies in South Africa aimed at inward-industrialisation and strategic self-sufficiency, skewed industrialisation towards the intensive use of capital. The structure of South African industry reveals significant capital-intensive activities such as the petrochemical, electricity, and non-ferrous metal industries. In contrast, labour-intensive industries in manufacturing, services and agriculture are characterised by low levels of investment and productivity. Moreover, within sectors policy incentives encouraged capital-intensive production rather than labour-absorbing techniques[38] (Labour Market Commission, 1996).

Future industrial strategy, supported by appropriate trade policies, must strive to increase the labour-absorptive capacity of the economy by encouraging greater use of less skilled labour, and more intensive use of capital and skilled labour. This rationale underlies successful policy formulation in a labour-abundant, capital-constrained economy such as South Africa. Accordingly, industrial and trade policy interventions need to facilitate greater labour-absorption in industry in a manner that enables re-orientation towards the export market and the improvement of productivity levels in labour-intensive industries. In addition, projects involving the capital-intensive beneficiation of natural resources, for instance Sasol and Mossgas, among others, need to be evaluated with regard to the cost of capital and import requirements, employment generation, and potential for labour-intensive downstream production.

It is within this context, and in accordance with current international practices, that South Africa is moving away from demand-side protectionist trade policies toward supply-side measures. *Demand-side* policies attempt to provide industrial protection by supporting

[38] Policy incentives that contributed to greater use of capital-intensive techniques included accelerated depreciation allowances, such as section 37E (Joffe et al, 1995).

final product prices. *Supply-side* policies, on the other hand, attempt to reduce the underlying industrial cost structure, thereby *reducing* final prices, improving productivity, and increasing international competitiveness. This policy shift is the key to a movement from inward-orientated production for the domestic market to export-orientated global competitiveness, growth and employment generation (Department of Trade and Industry, 1995).

However, supply-side policies will not achieve imminent reductions in industrial cost structures. There is an inherent time lag in industrial restructuring that varies from industry to industry. In addition, the Department of Trade and Industry (DTI) has recognised that although skill upgrading and increases in income will facilitate a reduction in income disparity in South Africa, it will not necessarily provide the impetus for massive job creation (Department of Trade and Industry, 1995).

Accordingly, the DTI aims to support labour-intensive industrial development by:

- strengthening competition policy, preventing the abuse of market power by dominant firms[39];
- deploying a range of measures to support and develop small, medium- and micro-sized enterprises (SMMEs)[40];
- encouraging increased international competition, particularly for producers of intermediate goods, enabling a reduction of input costs for downstream producers[41];
- securing wider access to international markets for traditional exporters, and emergent SMME exporters (Labour Market Commission, 1996).

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[39] South African competition policy is presently being substantially reformed to address the abuse of market power by dominant firms - a substantial contributor to allocative and productive inefficiencies in South African industry. Excessive industrial conglomeration and the concentration of ownership among a 'business elite' - is particularly controversial in an economy characterised by extreme socio-economic inequalities. Gerson (1993) estimated that in 1993 six dominant conglomerate groups - Anglo-American, De Beers, Rembrandt, Old Mutual, Sanlam, and Liberty Life effectively controlled about 80% of assets reflected on the Johannesburg Stock Exchange. Consequently, competition policy reform - a key element of socio-economic transformation with regard to efficiency and equity concerns - has been particularly contentious, and is presently at the forefront of the agenda for debate in NEDLAC (Business Day, 1996).

[40] The DTI notes that improving manufacturing performance can assist, but cannot provide the panacea to the need for substantial employment at the lower-end of the labour market. Competition policy reforms aim to reduce the stranglehold of 'big' business on the South African economy, and actively encourage the participation of SMME producers.

[41] Import-parity pricing, particularly for producers of intermediate goods, has been a key contributor to high input-costs in down-stream industries, rendering these industries uncompetitive on the international market (Joffe et al, 1995).

Nevertheless, these measures may be insufficient to meet the required demand for employment creation. The Labour Market Commission recommends that additional policy support explicitly target labour-intensive production by focusing on those industrial sectors - clothing, furniture, footwear, tourism, construction, metal fabrication, and auto components - that display relatively high labour:capital ratios. These sectors presently feature few firms that are globally competitive - the majority of firms exhibit low levels of productivity. Policy interventions should therefore concentrate on strategies to *raise productivity levels* in labour-intensive sectors (Labour Market Commission, 1996).

The above discussion on industrial strategy in South Africa bears distinct implications for the proposed EU-South Africa FTA:

- In the short-term South Africa's exports to the EU will remain heavily biased in favour of agricultural products. Industrial restructuring will only change export composition in the medium- to long-term.

- The FTA needs to be structured in a manner that will support the development of labour-intensive productive sectors, such as the pulp and paper, footwear, clothing (particularly in the Western Cape, and Kwazulu-Natal), motor vehicle component, fruit processing and canning, and tourism industries among others, complementing DTI policies to facilitate employment creation in these industries.

- The FTA should be based on a negative list of products, rather than a positive list of products included in the agreement. This would reduce the risk that of a larger number of products being excluded from the FTA as South African manufacturing diversifies in the medium- to long-term (Jenkins and Naudé, 1995).

- Finally, the proposed FTA must be appropriately structured, and attendant policy interventions sequenced so as to limit short-term job loss resulting from trade reforms. There is little guarantee that employment concerns are prioritised in the EU mandate as it now stands.

3.2.1.6 *EU Exports to South Africa*

Similar 'sensitivity' exercises were undertaken with regard to the EU's exports to South Africa. Stevens and Kennan (1995) identified 165 products (at the 8-digit HS level) for which EU exports to South Africa exceeded Ecu 5 million in value, and which face substantial trade barriers in the South African market (the most important product groups are tabled in Appendix 8, Table 7). Those products which showed significant levels of export growth to South Africa include electrical machinery and equipment, vehicles, machinery and appliances. Products which exhibit an annual average growth in exports of in excess of 5% and 1993 export value greater than Ecu 50 million are pharmaceutical products, medical and optical instruments, books and newspapers, and miscellaneous chemical products. Meat, aircraft parts, man-made fibres and beverages have showed a decline in exports to South Africa.

South Africa's recent offer to the Uruguary Round of GATT implies that the resulting GATT-binding tariff levels are relevant to policy-relevant EU exports, rather than current tariff levels. As the binding GATT rates were higher than actual tariff rates for the majority of products concerned at the time of the GATT offer, recent DTI efforts to reduce *binding* rather than actual levels will not entail dramatic adjustment costs (Business Day, 1996). Nevertheless, EU-South Africa FTA negotiations will consider the impact of differential tariff liberalisation for EU exports *beyond* bound tariff rates. This implies differential adjustment costs for industries - products may be categorised into those where further tariff reduction is possible, and those which are particular sensitive for the South African market and which might even experience an *increase* in tariff protection.

A large proportion (49%) of EU exports to South Africa will experience substantial tariff cuts under the Marrakesh Agreement transition period. The most notable of these products are motor vehicles and parts, whiskies, medicaments and computer programmes. Nevertheless, as the GATT-binding tariff rates for South Africa are not zero, there still remains scope for EU negotiation for further tariff cuts for those products which will still do not enter duty free into the South African market.

Those policy-relevant products which have been defined as 'sensitive' for the South African market and which will face either first-time tariff imposition or tariff increases include telephone and electrical apparatus, bottling machinery, medical instruments,

packing machinery, and aircraft and engine parts. These two product groups are not foreseen to be an immediate major stumbling block in EU-South Africa FTA negotiations as in 1993 they comprised only R5.7 billion of exports to South Africa, and are not viewed as sources of imminent export growth into the South African market.

3.2.2 Dynamic Gains and the proposed EU-South Africa FTA with particular reference to 'Employment-Sensitive Industries'

There is considerable debate about how further tariff liberalisation in a negotiated EU-South Africa FTA would impact on particularly employment-sensitive industries, such as the clothing and motor vehicle industries. For the most part, South African industry is riddled with structural deficiencies due to ad hoc protection directed toward strategic, inward-industrialisation during the apartheid years. Reduced protection in many South African industries is essential to increase foreign competition, encouraging substantial industrial restructuring, and technological upgrading in an effort to remain competitive in a global market. Increased competition would yield dynamic gains in terms of increased economic efficiency due to intensified competition. Industrial rationalisation and a focus towards the export market would allow for the exploitation of internal economies of scale, and reduced cost structures, improving the international competitiveness of South African industry (Black, 1995).

These dynamic effects are particularly important to South Africa when negotiating an integration agreement such as the proposed EU-South Africa FTA. However, employment-intensive industries, specifically the clothing and textile, and the motor vehicle and parts industries would experience certain job losses and adjustment costs during initial restructuring following implementation of the FTA[42].

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[42] Chang (1994) outlines the inherent tension between the need for efficient resource allocation and the resultant adjustment costs in industrial restructuring in terms of asset - both human and physical - specificity. That is, there are practical 'costs' to restructuring which are not present in a perfectly competitive theoretical construct. 'Perfect competition' assumes that competition will yield optimal market outcomes via free entry and exit of firms. However, this reasoning assumes that resources invested in exiting/ 'bankrupt' firms can be instantaneously and costlessly shifted to other firms, or to more efficient activities. In the South African circumstance, industrial restructuring requires both the re-training and re-skilling of labour, technological innovation and the upgrading of capital equipment. This is not a costless, instantaneous process. It requires specific investments in physical and human capital, which only yield returns in the medium- to long-term. This argument provides a certain rationale for

3.2.2.1 *The Clothing Industry*

The clothing industry is an important source of labour-intensive employment, specifically in the Western Cape, and Kwazulu-Natal. Beset by low levels of productivity and high unit labour costs[43], the industry requires substantial restructuring to be able to compete in international markets.

Despite relatively low real wages, strategies to improve productivity have concentrated on reducing labour costs via retrenchment and wage suppression. Given that the workforce of the clothing industry is predominantly female and unskilled[44], these strategies further entrench gender and racial income inequalities at the lowest rung of the labour market[45] - outcomes which are contrary to the tenets of reconstruction and development in South Africa.

Already, between September 1995 and February 1996 restructuring in the clothing, textile and leather industry has cost 17 700 jobs - around 10 000 of these jobs being lost in the clothing industry alone. This will entail further job losses in related and auxiliary industries. In addition, the breadwinner to dependent ratio within the clothing industry indicates that about 188 000 direct dependants have lost access to their main source of income provision as a direct result of such employment losses (Patel, 1996). These figures reveal the extent of socio-economic deprivation caused by industry restructuring and rationalisation, and highlight the need for strategies to be sensitive to employment needs.

Labour regulation, low real wages and high levels of unionisation compel the clothing industry to look beyond wage bill reduction toward improved firm organisation and new

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conditional protection for certain 'sensitive' industries subject to significant adjustment costs during restructuring.

[43] Refer to Altman (1993).

[44] Valodia (1995:13) indicates that the textile, clothing and leather division of manufacturing production is 64% feminised. He states that "liberalisation in South Africa may...have a severe impact on women's employment in the clothing, textile and leather industries. In all industries, the most vulnerable workers usually bear the burden of costs associated with adjustment. Women are therefore likely to bear a disproportionately large burden of adjustment costs."

[45] See Budlender, D., 1995, Profile of South African Women, The Women's Budget, Draft, Institute for Democracy in South Africa: The Budget Information Service

work practices in the drive to raise productivity[46]. Large sustainable cost reduction may be achieved by reorganisation of the factory floor, material usage, technological upgrading and supplier changes, and improved training and grading structures (Altman, 1993).

The adoption of new organisational and work practices is essential to improve the clothing industry's long-run competitive advantage, and may be encouraged by a 'carrot-stick' approach. There is provision in South Africa's offer to GATT that the clothing industry continue to receive a certain degree of protection, but that this should be linked to productivity and export performance. Altman (1993) argues that additional export incentives be tied to a composite indicator including export sales, employment and productivity.

Although EU exports to South Africa do not have the potential to swamp the domestic market as do Chinese clothing imports, there is concern that complete tariff liberalisation toward the EU market will prevent the South African clothing industry from developing potential to compete in higher-value added niche markets as the industry restructures[47].

Moreover, complete tariff liberalisation toward the EU market will undermine the 'carrot-stick' approach designed to encourage the adoption of new organisational and work practices. While enhanced competitive pressures and larger markets will improve productive and allocative efficiency and increase economies of scale, inclusion of the clothing industry into an EU-South Africa FTA must take cognisance of industry dynamics while restructuring. Negotiations should concentrate on strategies to *support* such restructuring. These might include initiatives to enhance training and technological upgrading, in addition to negotiated tariff, export and import arrangements, allowing for asymmetry in both timing, content and structure of the FTA.

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[46] Traditionally, labour input has been an important cost component in the clothing industry, and the easiest to vary. However, recently there has been a move to recognise functional flexibility (i.e. multi-skilling and/ or multi-tasking) in the drive for long-run competitive advantage (Altman, 1993).

[47] Prinsloo (1996) emphasises the need for further research on the impact of proposed tariff restructuring in the clothing industry. Noting that the lower-end of the market will be threatened by the lower-cost imports, particularly from China, Prinsloo (1996:23) argues that the (Durban) clothing industry "will have to shift its focus towards the middle- and upper-end of the income spectrum".

3.2.2.2 *The Motor Vehicle Industry*

The impact of tariff reform on the motor vehicle industry is also contentious. Lack of foreign competition due to significant levels of protection, and a concentrated domestic market have contributed significantly to market inefficiencies and oligopolistic abuses. In addition, ad hoc protection has encouraged market dominance by few motor vehicle assemblers. The importance of capturing market share has resulted in each motor assembler producing a proliferation of models in an industry which is characterised by considerable internal economies of scale. Consequently, insufficient specialisation has restricted economies of scale, leading to high unit costs. This has inhibited competitiveness on the international market, and added to inadequate technological innovation.

The industry is also subject to internal tensions between vehicle assemblers and component suppliers. Considerable internal economies of scale have remained unexploited due to excessive tariff protection resulting in a proliferation of models. Component suppliers have been campaigning for rationalisation within the industry so that they can produce higher volumes of parts of fewer types. This would reduce their unit production costs, allowing them to become more internationally competitive (Black, 1995).

South Africa's offer to GATT commits the motor vehicle industry to specific tariff reduction. A comprehensive seven year restructuring programme has recently implemented and will facilitate considerable structural adjustment and rationalisation in the motor vehicle industry by 2002. It is planned that at the end of this period, motor vehicles will still require tariff duties of 40% and 30% for motor vehicle components. Import complementation incentives will encourage export production, allowing competition on the international market to permit economies of scale and prevent productive inefficiencies resulting from unconditional tariff protection (Black, 1996).

Industrial restructuring requires considerable re-orientation of capital equipment and re-skilling of labour - processes which demand significant time, effort and investment. It is argued that while increased competition from EU rivals may demand overdue restructuring by South African motor vehicle assemblers, the complete reduction of tariff barriers as required by a reciprocal FTA would not allow sufficient time for industrial

restructuring. This could lead to the virtual elimination of the South African motor vehicle and component industry in the medium- to long-term.

GATT permits a maximum phasing in period of ten years for tariff liberalisation in sensitive areas, experts contend that a ten year period will not allow for sufficient restructuring in the motor vehicle and component industry. They argue that the dynamics of the industry, and necessary technology and capital inputs require a longer phasing in period (Stevens and Kennan, 1995, Black, 1996). In addition, there is concern that a FTA with the EU would bias the sourcing of components towards duty-free imports from the EU, upsetting relations with Japanese suppliers and domestic component producers (Black, 1996).

Finally, the South African motor vehicle industry, as is presently structured, yields considerable employment to the unskilled. Accelerated industrial restructuring would have severe consequences for employment losses in regions (particularly the Eastern Cape) which are already subject to high levels of unemployment.

While inclusion of the motor vehicle and component industry into an EU-South Africa FTA would yield certain benefits to South African producers, it would endanger the long-term viability of the industry. Present import complementation arrangements have encouraged industrial restructuring and led to a sharp rise in exports (Black, 1996). FTA negotiations need to consider possible exclusion of the motor vehicle and component industry, or conditional inclusion, dependent on further research to assess complementarity of arrangements with the EU to the present restructuring programme.

CHAPTER FOUR

Policy Implications of an EU-South African Free Trade Agreement

There are strategic political and economic reasons why South Africa should benefit from an EU-South Africa FTA in the long-run. The trend towards bilateral and multilateral free trade agreements has led to the formation of global trading blocs. Reciprocal trading agreements between developed and developing countries have superseded concessionary trade preferences in the international trade regime. It is argued that those countries which sit on the periphery of, or are marginalised from, the major trading blocs will forfeit both trade and investment, impeding economic growth and development.

An EU-South Africa FTA may confer dynamic benefits on South Africa by influencing economic growth and development in the medium- to long-term. Jenkins and Naudé (1995) argue that a reciprocal FTA, such as the EU-South Africa FTA, can enhance macroeconomic policy credibility, improving prospects for socio-economic transformation without constraining the role of government. In addition, a FTA with the EU, if appropriately structured, could positively influence both human and physical capital accumulation, and the building of technological expertise in South Africa - key ingredients in socio-economic reform.

4.1 Can the EU-South Africa FTA Enhance Policy Credibility?

Motivation for an EU-South Africa FTA to enhance medium- to long-term policy credibility does hold a certain intuitive appeal. Jenkins and Naudé (1995:11) argue for the FTA as a form of 'commitment technology' - locking-in trade and industrial, and macroeconomic reform, making policy reversal costly for government. This reasoning, while beneficial for broad policy debate, is insufficient at the policy decision level. South Africa industry will suffer severe structural adjustment costs in the short-term due to accelerated tariff reform under an EU-South Africa FTA. Policy decision makers need to be confident that dynamic gains will occur in the medium- to long-term, and understand

the nature of such gains, if they are to conclude an agreement with the EU. This requires policy makers to examine the argument motivating for an EU-South Africa FTA to enhance policy credibility, within the context of socio-economic reform and recent economic policy developments, in particular the government's release of its strategy for macroeconomic reform.

More specifically, policy makers need to ask why policy credibility is important for South Africa during socio-economic restructuring? And how can the implementation of a FTA with the EU enhance such policy credibility, improving medium- to long-term prospects for improved economic growth and development in South Africa?

4.1.1 Why is Policy Credibility Important for Socio-Economic Reform in South Africa

International experience indicates that successful economic restructuring, that is the re-orientation of trade and industrial policy towards achieving international competitiveness, depends on the sustainability of trade reform, and its coherence with macroeconomic objectives and strategy[48].

The key to sustainable liberalisation periods lies in the credibility of the policy package. If investors believe that policy reforms will be reversed due to political pressure, investment - both domestic and foreign - will be curtailed until economic certainty is restored.

Insufficient investment is a contributing factor to South Africa's economic ills. The rate of growth of capital stock, in addition to the productivity of both capital and labour, play a central role in the performance of the South African economy. Domestic investment levels have been declining for the past decade, and in the early 1990s South Africa was investing less than half the amount of investment of comparable developing countries (Joffe et al,

[48] In an extensive study of economic liberalisation and restructuring in developing countries, Papageorgiou et al (1991) conclude that the success of liberalisation policies is directly linked to the conduct of macroeconomic policies - *sustained* economic liberalisation and restructuring periods are premised on the conduct of restrictive macroeconomic policies, and expansionary macroeconomic policies are associated with *abortive* liberalisation episodes. Debate reigns as to whether such restrictive macroeconomic policies are imposed at the cost or benefit of higher economic growth. Evidence is inconclusive in support of either argument. However, Papageorgiou et al (1991) assert that liberalisation impacts positively on economic growth.

1995). Political instability and counter-acting macroeconomic[49] policies have been the key causes of lacklustre investment growth.

South African policy makers must be aware of the benefits that integration with a developed state, such as the EU, could have for improving the investment climate in South Africa. Integration will provide a larger market to potential investors, and a greater range of investment opportunities[50]. In addition, improved allocative and productive efficiency in the South African economy due to increased competition from EU imports will further enhance the efficiency and profitability of investment opportunities.

However, a positive investment climate depends on a range of economic and political factors, which include:

- political[51] and economic stability, with particular regard to the macroeconomic environment;
- proven track record in sustained economic growth;
- labour market stability;
- investment incentives;
- competitive tariff regime;
- competitive expected returns on investment (Department of Finance, 1996).

Consequently, although 'economic' integration with the EU can provide a certain credibility to economic policy in South Africa, the successful negotiation and implementation of an EU-South Africa FTA is itself not sufficient to cause a dramatic increase in either foreign or domestic investment in South Africa. Negotiations with the

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[49] Private sector investment in South Africa has responded to trends in domestic demand. This indicates that public sector investment in fact 'leads' private sector investment. Public investment fell during 1976 to 1980, followed by a precipitous decline parastatal investment after 1985, due to the privatisation of Sasol (1987) and Iscor (1989). Private investment trends have paralleled those of public investment, but have showed greater response to recessions induced by balance of payment constraints, and higher interest rates (Fallon and Pereira de Silva, 1994).

[50] An EU-South Africa FTA may be susceptible to the 'hub and spoke' syndrome, whereby Europe remains the 'hub' of investment activity and South Africa, the trading 'spoke'. This will apply if trading costs within South Africa, for instant transport costs, are higher than those between Europe and South Africa due to inadequate infrastructure. A 'hub and spoke' situation could provide a deterrent to FDI in South Africa, although increased two-way trade between the EU and South Africa has historically generated greater investment in South Africa. Prevention of a 'hub and spoke' situation would depend on infrastructural improvements in South Africa, in addition to further unilateral trade liberalisation, or by South Africa increasing its network of reciprocal trading agreements (Jenkins and Naudé, 1995).

[51] The international community has highlighted soaring crime as a serious threat to internal political stability in South Africa, and a sure deterrent to increased foreign investment (Business Day, 1996).

EU must rather seek to complement domestic macroeconomic, trade and industrial, and labour market reforms, in enhancing the investment and economic climate in South Africa.

An EU-South Africa FTA may further enhance domestic policy credibility if its successful implementation is partially dependent on the harmonisation of policies and regulations with the EU. However, 'watch-dog' parliamentary committees, notably the agriculture, trade and industry, and foreign affairs portfolio committees[52], have sharply criticised EU attempts to link the FTA negotiations to demands on competition policy, procurement and intellectual property rights. They are concerned that pressure by the EU for convergence in these areas will undermine integrity in domestic policy making[53] (Business Day, 1996).

This debate highlights the inherent tension between maintaining integrity in domestic policy making, and enhancing the credibility of such policy reform. Policy makers need to be aware of this intrinsic trade-off, and try to maintain an optimum balance. This means that policy makers should fully understand what is meant by 'policy credibility', and how negotiation of an EU-South Africa FTA can enhance such credibility.

4.1.2 What are the Elements of Policy Credibility, with specific reference to South Africa? Can Negotiation of an EU-South Africa FTA Enhance Policy Credibility?

Credibility of policies is dependent on their level of compatibility and time-consistency. Firstly, *compatible* macroeconomic policies allow external balance (i.e. balance of payments equilibrium). This means that over a defined planning horizon, current account deficits must equal the present value of future trade surpluses. This introduces an intertemporal constraint on the balance of payments account. Current account deficits can

[52] The agriculture, trade and industry, and foreign affairs parliamentary portfolio committees are calling for submissions from the public as regards concerns over the EU-South Africa FTA on 7 October 1996. This paper forms the basis for a submission from IDASA: Budget Information Service.

[53] The institutional dimensions of regional/ 'economic' integration are often ignored, but may well exceed the direct trade implications of such integration. Integration of any sort implicitly confers some common rules of conduct and certain reciprocal commitments for the integrating states. This paper does not examine institutional implications for South Africa from forming a FTA with the EU. However, the 'preference-dilution' effect whereby integration implies a larger political community and therefore a smaller role for domestic policy, is of particular concern to South African policy makers charged with implementing socio-economic reform. Further analysis on an exploratory model which examines the institutional dimensions of regional/ 'economic' integration is undertaken by De Melo et al (1994).

be financed in the interim by capital inflows, i.e. either foreign direct or portfolio investment, or government borrowing; but sustainability on the balance of payments demands that these deficits are equalled by future current account surpluses to repay borrowings, and the repatriation of profits from foreign-owned firm, in particular.

Policy makers need to ask whether South African macroeconomic policies have been consistent in the past, if they presently maintain consistency, and whether an EU-South Africa FTA can contribute to policy consistency. This requires closer examination of the structure and recent history of the South African economy.

During the 1980s, when South Africa was isolated from international capital markets, increased imports had to be financed by increased export earnings rather than by capital inflows. In addition, the economy was required to repay certain foreign borrowings during this period. Current account *surpluses* were required to finance the necessary capital outflows. The degree of import intensity of the South African economy and its inability to access new international credit meant that such capital outflows were managed at the cost of less domestic investment and a decline in economic growth.

The acceptance of South Africa into the international community following democratic elections in 1994 has to some extent alleviated the balance of payments constraint. Since 1994, South Africa has received approximately R30 billion in net capital inflows (Department of Finance, 1996:27). These capital inflows have financed current account deficits - increased imports have fuelled domestic investment and allowed a resurgence of economic growth. However, foreign capital has entered South Africa in the form of portfolio flows, which are easily reversible, rather than in more sustained direct investment.

Foreign direct investment (FDI) is preferable to portfolio investment as it is less volatile, and may be reliable source of financing of current account deficits during periods of economic growth. In addition, FDI also provides a critical input to growth and development by:

- transferring technological innovations and expertise;
- improving skill training and enhancing managerial expertise;
- assured access to international finance via 'parent' firms, and to export markets (Department of Finance, 1996).

Nevertheless, South Africa cannot rely only on continued capital inflows - albeit portfolio investment or FDI - to finance increased imports in the long-term. Sustainability must come from a more favourable balance on the current account of the balance of payments. This requires a long-term rise in South Africa's export earnings. Reciprocal trade arrangements, such as an EU-South Africa FTA, can facilitate an increase in exports. This will ensure that liberalisation contributes to external balance, if accompanied by appropriate macroeconomic policies.

The above analysis underscores the need for consistent and coherent macroeconomic policy in economic restructuring in South Africa. Specifically, increased sustained foreign investment will not occur until the international community is convinced that trade liberalisation is supported within a macroeconomic policy framework that is both consistent and will deliver on the socio-economic programmes of the RDP. Present *restrictive* monetary and fiscal policies will only retain consistency if they permit the RDP to effect sufficient delivery on socio-economic needs. If delivery is perceived to be delayed, the government will be pressurised to succumb to populist macroeconomic policies.

Secondly, *time consistency*[54] of policy requires that the policy should be in the government's own interests if it is to be perceived to be credible. Trade liberalisation may be perceived as being time inconsistent if it is endogenous (i.e. is set according to certain criteria or 'policy rules' - for instance, tariff levels are raised to curb imports when the current account deficit approaches a critical level), or if it is accompanied by time inconsistent macroeconomic policies, such as a decline in the bank rate when the money market shortage reaches an 'acceptable' level. Endogenous policies lack credibility as they are a response to a specific set of circumstances, and may therefore be reversed when those circumstances change.

On this score, South African policy makers should question whether policy reforms have been implemented in response to a specific set of economic and/ or political

[54] Discretionary policy, i.e. flexibility in policy decisions, is often thought to be superior to fixed policy rules. The case for rules over discretion arises from the problem of *time inconsistency* of policy. For instance, in certain cases, policy makers might want to announce policy in advance so as to influence expectations of economic agents. If policy makers attempt to reverse their announced policy once private decision makers have acted on the basis of their expectations, future policy announcements may be distrusted. In this situation, under the expectation that policy makers may be inconsistent over time, policy makers may want to consider committing to a fixed policy rule (Mankiw, 1992).

circumstances, or due to effective lobbying by powerful interest groups; or represent a definite commitment to socio-economic reform as declared under the RDP. Can the negotiation of an EU-South Africa FTA enhance policy credibility by improving time consistency of policy? Are present policy reforms, in particular the government's strategy for macroeconomic reform, sufficient for policy to be perceived as 'credible', or does policy credibility require the negotiation of reciprocal agreements, such as the EU-South Africa FTA to lock-in socio-economic reform? Answering these questions requires closer examination of both trade and industrial, and macroeconomic policy reforms.

4.1.2.1 *Do Recent Policy Reforms Represent a Definite Commitment to Socio-Economic Reform in South Africa?*

Polices on trade reform reveal that the South African government has expressed a definite commitment to trade liberalisation with its offer to GATT under the Uruguay Round. Further trade reform, as envisaged under the proposed EU-South Africa FTA, indicates the government's declaration of trade liberalisation beyond GATT requirements. In addition, recent initiatives on competition policy[55] have tackled the complacency of both business and labour. Such moves imply a definite policy change, rather than reactions to policy rules, or to powerful interest lobbies.

The government has also made great strides to enhance the credibility of macroeconomic policy by developing a bold, consistent, integrated strategy for macroeconomic reform. The 'Growth, Employment and Redistribution' (GEAR) strategy, released in June 1996, links fiscal discipline, wage and price restraint, and industrial and export promotion measures to boost economic growth to 6% per annum and annual job creation to 400 000 by the year 2000 (Department of Finance, 1996).

The GEAR medium-term macroeconomic strategy was developed in recognition that while the South African economy is on track for an average 3% growth per annum over the next few years - exports and investment are rising, the deficit is being reduced, and inflation is held in check - the present growth path will be unable to generate sufficient jobs for a growing labour force. Under the present scenario, annual job creation will lag at

[55] See Department of Trade and Industry (1995).

around 100 000 jobs per annum, yielding a rise in the unemployment rate to 37% by the year 2000.

The integrated macroeconomic strategy aims to tackle structural deficiencies in the South African economy, building competitive capacity in the long-term. The objectives are to accelerate growth and improve employment performance in the five year period until the year 2000. This will be achieved by:

- tighter fiscal reform - further reduction of the budget deficit will enforce anti-inflation measures, medium-term deficit targets will contribute to the elimination of government dissaving[56], additional tax reform, and restructuring the budget process will facilitate effective budget reprioritisation in line with the RDP;

- gradual relaxation of exchange controls, continued anti-inflationary monetary policy, and management of the real exchange rate at a stable, competitive level;

- additional trade and industrial reforms, including further tariff reduction to compensate for the recent depreciation of the real exchange rate[57], tax incentives over a specific period to kick-start investment, focused development of the SMME sector, strengthened competition policy and industrial cluster support programmes;

- restructuring public sector assets by selling off non-strategic assets, developing strategic partnerships with the private sector and foreign investors, particularly in the transport and telecommunications sectors, and reforming the 'governance, regulation and financing of public corporations' to improve efficiency and productivity in the public sector[58];

- a driving public sector infrastructural investment programme to address socio-economic backlogs, particularly in rural areas, and to provide the necessary infrastructure for regional and industrial development;

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[56] Government dissaving may be defined as current expenditure in excess of current revenue.
[57] Since February 1996 the rand has been under intense speculative pressure due to an adjustment correcting overvaluation of the currency, and uncertainty about government economic policy. For further discussion, see Department of Finance (1996), Appendix 2.
[58] A critical element of public sector restructuring is forcing a 'hard budget constraint' onto public sector operations, removing the possibility of loss-making centres being cross-subsidised by more profitable state ventures.

- labour market reforms that will allow greater flexibility as negotiated within a strengthened collective bargaining process. This will facilitate consideration of varying firm size, skill levels, degree of capital or labour intensity, and regional circumstances in wage determination processes[59], and introduce flexible employment and work processes to enhance labour absorption;

- a tripartite social accord between government, business, and labour that will facilitate wage[60] and price restraint, holding inflation in check, and accelerate investment, employment generation and improve public sector delivery in socio-economic reform (Department of Finance, 1996:5-6).

The strategy projects that over the period 1995 to 2000 these integrated measures will:

- raise the growth of non-gold exports to 10% per annum;
- encourage the growth of private investment at an average rate of 12% over the period;
- increase gross domestic savings from 18% to 22% of Gross Domestic Product (GDP), and gross domestic investment from 20% to 26% of GDP;
- necessitate capital inflows to the extent of 4% of GDP to finance current account deficits[61];
- increase GDP growth to 6% by 2000;
- increased employment generation to 400 000 jobs per year by 2000, facilitating a *decline* in the unemployment rate (Department of Finance, 1996:7).

The 'Growth, Employment, and Redistribution' macroeconomic strategy represents government's prioritisation of macroeconomic reform. Firm commitment to a consistent macroeconomic reform package will promote investor confidence, improving both domestic and foreign investment. In fact, the international investment rating agency, Standard and Poor, has endorsed the strategy as a "consistent and coherent plan that could boost South Africa's credit worthiness if implemented successfully, despite volatility in the

[59] Wage levels are influenced by a complex range of factors including market forces, sector characteristics, regional standards and cost of living, capital intensity and level of required technological expertise, racial and gender composition of employment, and level of unionisation of employees (Labour Market Commission, 1996).

[60] Productivity linked wage increases will minimise the threat of a wage-price spiral, breaking inflationary expectations. Re-inforcing stabilisation measures including further tariff reduction, tighter fiscal reform, and a firm, restrictive monetary policy stance, will choke-off rising inflation, maintaining the real exchange rate at a stable, competitive level as the economy expands.

[61] Balance of payments financing requirements means that the macroeconomic strategy is dependent maintaining a favourable investment climate in order to attract foreign investment.

currency markets". This sentiment is echoed by the International Monetary Fund which sees GEAR as "having begun to set the stage for a gradual strengthening of growth performance, although unemployment will remain relatively high for some time (Business Day, 27 September, 1996).

Government has stated that certain parts of the macroeconomic strategy, particularly tighter fiscal reform and continued restrictive monetary policy, are not negotiable. Consequently, the strategy as a whole has not been tabled at the National Economic Development and Labour Council (NEDLAC), although micro-strategies are currently part of NEDLAC deliberations. However, the integrated package is predicated on the operation of a social accord - for instance, public sector asset restructuring and wage moderation underlie fiscal reform and anti-inflationary policies[62]. By definition, a social accord is a negotiated agreement. Successful implementation of the macroeconomic strategy will depend on government achieving consensus with labour and business on the various micro strategies through deliberations in NEDLAC.

4.1.2.2 *Will an EU-South Africa FTA Benefit Policy Credibility in South Africa?*

Proponents argue that the implementation of a negotiated FTA with the EU would facilitate sustained trade liberalisation, as it would lock-in trade and accompanying prudent macroeconomic policies, raising the stakes for their reversal (Jenkins and Naudé, 1995). This would reduce political pressure on government to succumb to populist demands in accelerating socio-economic delivery.

It is also contended that the stability of EU macroeconomic policies would feed through to South Africa due to the need for policy coherence between partner countries. This would enable South Africa to gain international credibility without acceding to the World Bank macroeconomic policy constraints placed on many developing countries undergoing economic restructuring.

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[62] Labour, specifically Cosatu leadership, is opposed to certain micro-strategies within GEAR, specifically wage moderation and public asset restructuring. However, recent deliberations between government, labour and business have seen progress in programmes to restructure public assets. This is seen as a definite move forward in negotiating a social accord for macroeconomic reform (Business Day, 1996).

These arguments do not, firstly, consider the need to balance the integrity of domestic policy making while improving the credibility of such policy; and secondly, the government's recent initiatives of macroeconomic reform. The integrated GEAR macroeconomic strategy indicates the government's commitment to pursuing consistent and coherent macroeconomic policies aimed at accelerating economic growth and improving employment performance.

Consequently, although not essential, if the proposed EU-South Africa FTA were appropriately structured, it would likely complement macroeconomic reform in improving the investment climate in South Africa. Policy credibility in macroeconomic reform is more likely to depend on the government's adherence to its proposed policy reforms, and its ability to meet macroeconomic targets, as detailed within the GEAR strategy. These events are time-dependent, and may only be assessed, in the first instance, at the outcome of the 1997/98 budget[63], and by the government's ability to bring the powerful labour lobby on board to achieve GEAR targets through specific policy deliberations within NEDLAC.

Nonetheless, trade negotiators must strike a fine balance in structuring an EU-South Africa FTA that will support, and not compromise, domestic policy reforms. Further, tough bargaining on the part of South African trade negotiators for the inclusion of a specific prohibition of anti-dumping suits in the FTA would prevent the EU from using contingent protection measures against South African producers, increasing the attractiveness of South Africa as a locale for FDI[64] (Jenkins and Naudé, 1995).

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[63] The Financial and Fiscal Commission, an advisory body to the government, has strongly criticised government's targets for deficit reduction, indicating that provincial delivery of socio-economic services will 'buckle' under the ambitious targets (Business Day, 1996). The strategy has also been strongly criticised by the 'leftist' economic think-tank National Institute for Economic Policy (NIEP). NIEP (1996) argues that the GEAR strategy is a drastic departure from RDP objectives, and will jeopardise socio-economic delivery. The NIEP critique of GEAR, like others, is for the most part the outcome of an ideological stand-off between the 'right' and the 'left' on the role of the government in economic transformation. However, NIEP (1996) does make a valuable contribution to the debate in questioning the impact of GEAR policy proposals on sectoral employment trends - a key concern at both the macro- and microeconomic levels.

[64] Although non-tariff protection has been virtually eliminated following the Uruguay Round of GATT, easier application for anti-dumping suits has increased the prevalence of 'contingent protection' measures. The EU is only second to the USA in its use of anti-dumping contingent protection. 95% of anti-dumping applications are successful, and 80% are concluded by the imposition of tariffs ranging from 20% to 97%. However, the EU-Iceland agreement has set a precedent by specifically prohibiting the application of anti-dumping suits (Jenkins and Naudé, 1995).

4.2 Inclusion of Industry-Specific Co-operation Agreements with regard to Training and Transfer of Technological Expertise

When weighing up short-term concerns about adjustment costs and longer-term dynamic gains, South African negotiators should add *positive* institutional inclusions to their list of considerations. An EU-South Africa FTA, if appropriately structured, could positively influence both human and physical capital accumulation, and the building of technological expertise in South Africa.

More specifically, inclusion of industry-specific co-operation agreements on training and job-skilling and the accumulation of technological and managerial expertise in an EU-South Africa FTA would build the necessary capacity and competitiveness underlying macroeconomic reform.

Why are these co-operation agreements so important to EU-South African negotiations? The answer lies in South Africa's structural legacy - a remnant of apartheid socio-economic policies.

4.2.1 Human Resource Development - the Key to Effective Reform

In the past, South Africa has lacked a commitment to training semi- and unskilled workers. Between 1985 to 1990 the number of workers attaining artisan status fell by 45%. In addition, an average of 1% of the wage bill is allocated to training in South Africa, compared to between 4% to 5% in developed countries (Labour Market Commission, 1996:43).

Human resource development (HRD), a key part of industrial strategy initiatives, should focus on the training and skill requirements of the manufacturing and services sectors - sectors which will generate job opportunities in the short- to medium-term. The magnitude of HRD requirement suggests that co-operation agreements and joint ventures with developed countries such as the EU, would enable key support of government's policies toward comprehensive macroeconomic reform.

Co-operation agreements on industry-specific training and re-skilling, if appropriately targeted and effectively implemented, would assist the phasing-in of supply side support measures aimed at human resource development, training, technological enhancement, and productivity improvement, and mitigate employment losses due to tariff liberalisation in predominantly unskilled industries. This would allow South African producers to reduce their cost structures and become internationally competitive.

4.2.2 Technological Transfer - the Development of a Technology Culture in South Africa

South Africa would also benefit from the inclusion of technological co-operation and joint venture agreements in an EU-South Africa FTA. Presently, South Africa spends 1% of GDP on research and development (R&D) activities (Kaplan, 1996:17). While this is comparable to a number of newly industrialising countries, over the last decade total expenditure on R&D has declined faster than capital expenditure. In addition, expenditure has focused on strategic sectors, such as armaments and atomic energy. These trends are of particular concern at a time when South Africa is intending to improve performance in the manufacturing sector and raise non-gold exports.

The importation of foreign technology and adaption to local circumstances is important in attaining competitive advantage in many industries. Technological expertise is tacit - it requires learning-by-doing for effective assimilation. For the most part, South African firms have entered into license agreements with foreign firms that often contain express provisions that inhibit the transfer of technological knowledge and skills. This re-inforces a passive dependence on foreign technological inputs, preventing the assimilation of technological expertise and the adaption of foreign inputs to local conditions (Kaplan, 1996).

An EU-South Africa FTA can facilitate the development of a vibrant technological culture by enabling an increase in 'imported' technology - that is, technology that is embodied in increased imports of capital equipment, such as electrical machinery and equipment, and machinery and appliances (Stevens and Kennan, 1995) - and by explicit industry-specific agreements to transfer technological 'know-how' and expertise to local industry. In addition, a larger market may facilitate technological spill-over effects, particularly in high-

technology industries, such as televisions and plastic products, which are significant South African exports to the EU (Stevens and Kennan, 1995).

4.3 Policy Trade-Offs between Short- and Longer Term Concerns

In conclusion, an EU-South Africa FTA would certainly contribute to dynamic gains in improving the medium-to long-term growth prospects of the South African economy. This chapter has attempted to highlight the dynamic benefits that an EU-South Africa FTA might bear in enhancing the credibility of macroeconomic reform, but notes the importance of maintaining integrity in domestic policy making. In addition, discussion emphasises the potential for negotiations with the EU to contribute to building capacity in human resource development and the accumulation of technological expertise. External economies of scale could also be achieved through greater EU-South African co-operation in infrastructural development - transportation and telecommunications networks[65] - and in co-ordinated research and development ventures.

Unfortunately these dynamic gains resulting from integration with the EU will be difficult to quantify and only become apparent in the medium- to long-term, while short-term costs are visible in industrial restructuring. In addition, industry-specific co-operation agreements and joint ventures in training and technological transfer may be negotiated at the level of the EU-South Africa FTA, or separately by individual EU countries outside of a FTA with the EU, i.e. they are not tied to the negotiation of an EU-South Africa FTA. Accordingly, the South African team will have to make careful choices in evaluating the trade-offs between long-term gains and short-term costs in negotiating a FTA with the EU.

[65] For instance, the EU-South African trade negotiations could include a focus on EU participation in the privatisation of Sun Air, the commercialisation of major airports in South Africa, and developing strategic partnerships in telecommunications.

CHAPTER FIVE

Conclusion

Negotiations on the proposed EU-South Africa FTA involve contentious debate on the appropriate structure and timing of an agreement that is mutually beneficial to both the EU and South Africa. The issues at stake are undeniably complex and involve substantial trade-offs. Consequently, both negotiating teams are entering into hard bargaining in an effort to balance short-term adjustment costs against longer term gains.

This paper has attempted to broaden the debate on *'How would South Africa benefit from a FTA with the EU?'*

Chapter One broadly sketches the motivation for negotiation of a free trade agreement with the EU. The importance of trade with the EU and the need to negotiate an appropriate trade policy regime following South Africa's transition to a political democracy in 1994 lay the foundation for present negotiations between South Africa and the EU. Partial access to Lomé IV will allow South Africa to enter into political dialogue with the EU, but excludes it from any trade concessions offered to Lomé members, on the basis of South Africa's comparably more developed economic status. Accordingly, negotiation of a FTA with the EU is intended to place South Africa on a par with similar middle-income developing countries.

However, there is considerable controversy around the *structure* and *timing* of the proposed EU-South Africa FTA. The Mediterranean bloc of the EU is concerned that South Africa's agricultural exports, particularly deciduous fruits and vegetables, will flood the EU market, threatening those 'sensitive products' covered by CAP. Consequently, the EU negotiating mandate proposes the exclusion of 39% of South Africa's agricultural exports to the EU. On the South African side, concern is rising about the possible impact of the EU-South Africa FTA on employment-sensitive industries, particularly the clothing and motor vehicle industries, in addition to proposed agricultural exclusions.

Chapter One concludes by proposing the over-arching question: *'Will South Africa benefit from a free trade agreement with the EU?'* This introduces the debate on short-term gains or losses against possible longer term dynamic gains, in addition to consideration of the opportunity costs and potential benefits for growth and development resulting from the proposed EU-South Africa FTA.

Chapter Two offers *theoretical* insight into the proposed policy questions, undertaking a tailored review of regional integration theory. This theoretical survey facilitates economic assessment of the potential impact of the proposed EU-South Africa FTA by considering short-term benefits and costs, in addition to the longer term dynamic gains of regional/ 'economic' integration between two trading partners.

Whilst static benefits and costs are of particular concern, negotiators should be aware of the potential contribution of dynamic gains to long-term growth prospects, particularly of a growing country such as South Africa. There is an inherent trade-off between short-term adjustment costs, and the longer term dynamic and growth benefits from an EU-South Africa FTA. Negotiators need to balance these concerns carefully when bargaining for an appropriately structured FTA.

Chapter Three attempts to apply insights offered by theoretical understanding to an economic assessment of the proposed EU-South Africa FTA. At a static level, Vinerian analysis and further inquiry into the theoretical benefits of free trade areas, specifically, provide an initial framework with which to analyse 'economic' integration between South Africa and the EU. However, in practice, the asymmetry of the proposed EU-South Africa FTA as regards the phasing of tariff reductions, in addition to the EU's exclusion of 39% of South Africa's agricultural exports to the EU, and the nature of historical trading links between South Africa and the EU, indicate that little static benefit due to trade creation is likely to accrue to South Africa.

Empirical analysis of potential static gains resulting from the proposed EU-South Africa FTA is inhibited by the unavailability of necessary data, such as import demand and export supply elasticities. Consequently, those studies reviewed do not attempt to tackle empirical questions. Instead, they concentrate on descriptive analyses of possible *static* gains to South Africa from the proposed EU-South Africa FTA. In particular, Stevens and Kennan (1995) provide detailed study of EU-South African trade patterns, clarifying potential short-term implications of the proposed FTA for both South Africa and the EU.

While there is little evidence to support fears that increased South African exports will adversely affect EU agriculture to any great extent in the short-term, the critical policy question is whether there is sufficient scope for changes in the composition of South African exports, particularly as regards manufactured goods, over the medium-term.

Medium-term restructuring of the South African economy is critical to improve economic prospects within the nascent democracy. It is within this context that South African negotiators need to consider whether the proposed EU-South Africa FTA is able to complement domestic macroeconomic, industrial and trade, and labour market reform aimed at the medium-term restructuring of the South African economy.

More specifically, the urgent call for labour-absorbing growth in the South African economy bears definite implications for the manner in which the economy is restructured, and therefore the appropriate form - in terms of *content* and *timing* - taken by the EU-South Africa FTA.

As studies reviewed do not consider the prospect of dynamic gains resulting from the proposed EU-South Africa FTA, Chapter Three attempts to draw out possible dynamic implications for South Africa of 'economic' integration with the EU. Analysis takes note of the potential dynamic benefits for South Africa - improved allocative and productive efficiency due to intensified competition, potential to exploit internal economies of scale, technological spill-over effects - but raises the debate about how further tariff liberalisation, beyond South Africa's GATT commitment, would impact on employment-sensitive industries, specifically the clothing and motor vehicle industries.

These debates highlight the structure of the proposed EU-South Africa FTA. The EU negotiating mandate proposes a FTA that is asymmetric as regards the *period* in which tariff barriers are reduced, in addition to the exclusion of particular agricultural products protected under CAP. However, specific South African concerns about the impact of accelerated tariff liberalisation on employment-intensive industries, such as the clothing and motor vehicle industries, facilitates the argument for an EU-South Africa FTA that is asymmetric in both *content* and *timing*. That is, negotiations should consider the unique internal dynamics of particular industries, and evaluate whether inclusion of these industries into an EU-South Africa FTA will be:

- advantageous to their restructuring; and
- aim to support labour-creation strategies.

Consequently, the EU-South Africa FTA should be structured in a manner that *supports* labour-intensive exporting industries, in an effort to improve labour-absorbing economic growth in South Africa.

Chapter Four rounds off the above discussion by considering the policy implications of an EU-South Africa FTA. These include the influence of 'economic' integration on the credibility of macroeconomic policy, in addition to its effect on human and physical capital accumulations, and the building of technological expertise in South Africa.

Expressly, Chapter Four details how the investment climate, and hence future economic growth prospects, are dependent on policy credibility. This highlights the debate on the tension between maintaining integrity in domestic policy making and enhancing the credibility of policy reform. Unpacking the elements of policy credibility allows an evaluation of the credibility of South Africa's macroeconomic policies.

Recent release of government's GEAR medium-term strategy for macroeconomic reform makes great strides in enhancing the credibility of macroeconomic reform. An appropriately structured EU-South Africa FTA, while not essential, may complement macroeconomic reform in improving the investment climate in South Africa. Chapter Four concludes that policy credibility is likely to be more dependent on the government's adherence to its GEAR medium-term macroeconomic strategy, and its ability to meet defined macroeconomic targets, than on the conclusion of a FTA with the EU.

In the final analysis, South Africa needs to 'steer an accurate course' in its negotiations over a FTA with the EU. The EU mandate presently on the table skews the distribution of benefits towards the EU, while adjustment costs fall squarely on South Africa. Gaining only 7% additional duty-free access into the EU market in return for allowing the EU an additional 40% duty-free access into the South African market, in the name of attaining credibility in tariff reform, amounts to short change by anyone's count (Business Day, 1996). The original EU offer of a FTA, aimed at 'normalising' economic relations with South Africa in a manner that would support development of the nascent democracy, has been subsumed by the reality of hard bargaining over substantial commercial interests. The EU stands to gain more from the EU-South Africa FTA than South Africa, at least in the short-term, and can afford to be generous to South Africa by negotiating an agreement that is asymmetric in both content and timing. This will reduce excessive adjustment costs

in South African industry, particular in terms of employment loss, due to accelerated trade reform.

Accelerating tariff liberalisation - directed at enhancing allocative and productive efficiency in South African industry - is certainly integral to the government's GEAR macroeconomic strategy. However, externally driven trade liberalisation may undermine the integrity of domestic policy reform, unless it is specifically structured to support such reforms aimed at enhancing labour-absorbing economic growth in South Africa.

Negotiations need to attach greater recognition to the relative capacities of the EU and South Africa. Accelerated tariff liberalisation coupled with restricted access for its agricultural exports will force South Africa to bear significant adjustment costs in industrial restructuring, and reap little, if any, gains from trade creation. In addition, substantial short-term costs dilute the marketability of potential dynamic and policy gains.

An EU-South Africa FTA structured in this manner is particular cause for concern, not only with regard to employment-sensitive industries, specifically clothing and motor vehicles, but also for the implications it has for restructuring industry towards labour-intensive exports.

EU-South African negotiations therefore need to:

- empirically evaluate the *actual* costs and benefits to both the EU and South Africa from integration, i.e. static gains from trade creation and trade diversion[66], in addition to the costs of structural adjustment during accelerated tariff liberalisation - this implies that research be driven by quantitative objectives, rather than be based on theoretical presumptions;

- recognise that the resulting agreement should be based on the principle of asymmetry in both *content* and *timing*;

- aim to support the restructuring processes within individual industries, particularly by inclusion of industry-specific training and technological transfer co-operation

[66] Empirical evaluation of static gains from trade creation and trade diversion requires estimation of import demand and export supply elasticities. This should be supplemented by empirical evaluation (possibly using computer general equilibrium simulation models) of potential dynamic gains and growth effects in the medium- to long-term.

agreements at the level of the EU within the FTA, as well as specific joint ventures in infrastructural development and telecommunications;

- be based on a negative list of products, rather than a positive list of products included in the agreement. This will reduce the risk that a larger number of products be excluded from the FTA as South African manufacturing diversifies in the medium- to long-term (Jenkins and Naudé, 1995); and

- be directed at complementing broader macroeconomic, trade and industrial, and labour market strategies aimed at employment creation. This will encourage labour-enhancing growth, facilitating socio-economic development in South Africa.

APPENDICES

Appendix 1

Table 1[1] Origin of South African Industrial Imports for 1994

Continent	% of World Total
Africa	2.5
Europe (excl. EU)	6.2
EU	44.9
Americas	14.2
Middle/ Far East	27.5
Australasia	1.1

Source: IDC, 1995

Table 2 Destination of South African Industrial Exports 1994

Continent	% of World Total
Africa	9.95
Europe (excl. EU)	8.65
EU	20.0
Americas	9.8
Middle/ Far East	17.1
Australasia	0.9

Source: IDC, 1995

[1] Note that percentages in Tables 1 to 4 do not necessary sum to 100% due to exports/ imports which are unaccounted for in terms of destination by Customs and Excise.

Table 3 Origin of South African Agricultural Imports 1994

Continent	% of World Total
Africa	13.9
Europe (excl. EU)	2.3
EU	25.0
Americas	31.3
Middle/ Far East	20.5
Australasia	6.9

Source: IDC, 1995

Table 4 Destination of South African Agricultural Exports

Continent	% of World Total
Africa	19.35
Europe (excl. EU)	3.15
EU	39.7
Americas	9.5
Middle/ Far East	27.4
Australasia	0.55

Source: IDC, 1995

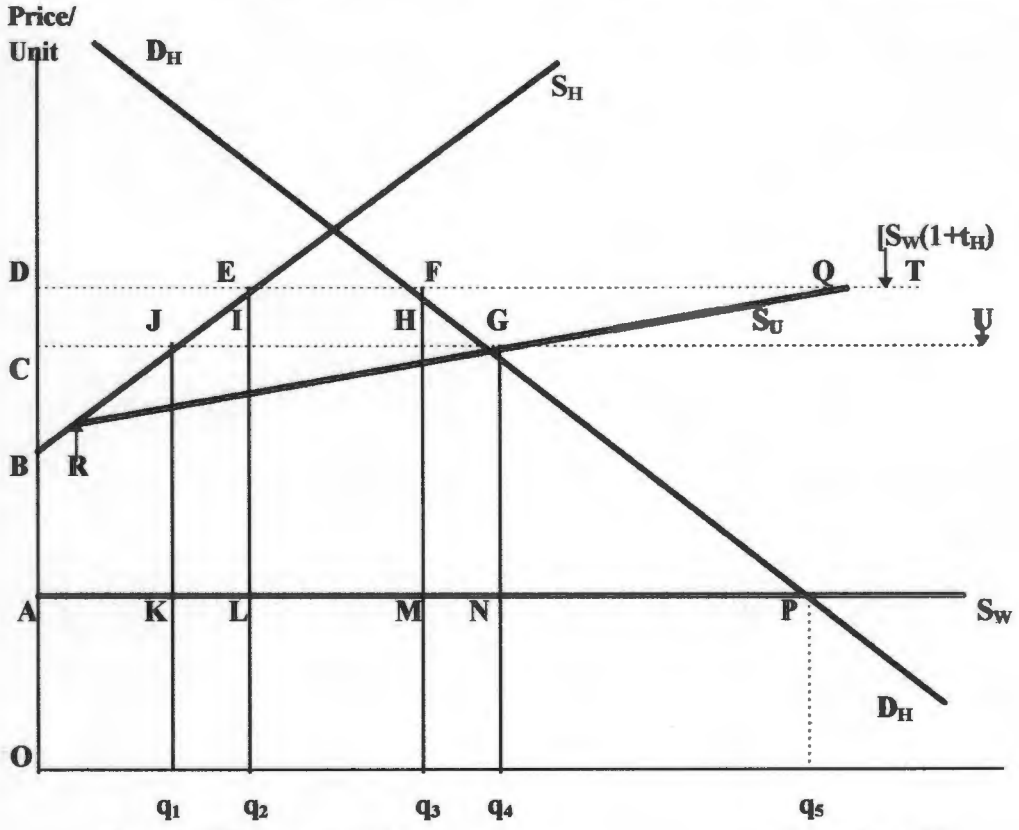
Appendix 2

The Vinerian Model

The Vinerian model assumes:

- three countries, the home country (H), the potential customs union partner (P) and the rest of the world (W); and two goods, one domestic and one import;
- perfect competition in both product and factor markets;
- full employment of all factors of production;
- zero transaction costs;
- perfect factor mobility within domestic economies, but imperfect factor mobility across national boundaries;
- prices determined by cost (accurately reflecting true opportunity cost); and
- constant costs of production.

Figure 1 **The Vinerian Model of Trade Creation and Trade Diversion**



Source: El-Agraa, 1990

In Figure 1[2] the world's supply curve for this commodity S_W is perfectly elastic and excludes tariffs, S_H is the home country's supply curve, and S_U is the union supply curve.

Prior to the union, the home country (H) imposes a non-discriminatory tariff of AD (= t_H). The effective supply curve[3] facing H is therefore BRJEFQ - its own supply curve up to E (the level of the tariff) and W's there-after, inclusive of the tariff t_H (i.e. $S_W[1 + t_H]$). The domestic equilibrium price of OD yields local production of Oq_2, but domestic consumption of Oq_3. Imports from the rest of the world, the lowest-cost producer, are equal to q_2q_3. The home country H purchases the imports from W at a cost of q_2LMq_3, whilst the domestic consumer pays a tariff-inclusive price leading to a cost of q_2EFq_3. The differential, LEFM, represents the tariff revenue accruing to the home country government, and is therefore a direct transfer from consumers to government in the home country.

If H and P form a customs union, the tariff t_H would be removed from imports from P but still apply to those from W. The effective supply curve facing the home country is therefore BRGQT - the home country's supply curve from B to R, the union curve (tariff-free) RGQ, and the world supply curve inclusive of the tariff $S_W(1 + t_H)$ from Q to T. The equilibrium price falls to OC, causing a decline in domestic production to Oq_1 and a rise in domestic consumption to Oq_4. Imports of q_1q_4 are now sourced from P, the *lower-priced* producer. (Imports from W are produced at a *lower-cost* to those in P but as they face a tariff of t_H, are less-competitive in price to those of P.)

Is the formation of a customs union between H and P welfare-enhancing? The static economic implications of such may be analysed in reference to changes to consumer and producer surpluses. Due to an increase in domestic consumption from Oq_3 to Oq_4, consumer surplus increases by the area CDFG - a portion of which, CDEJ is a direct transfer from producers to consumers due to a fall in domestic production, and area IEFH is a transfer of tariff revenue from the government to consumers. This leaves welfare gains of areas JEI and HFG due to trade creation resulting from the formation of the customs union between H and P.

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[2] In Figures 1 to 5 areas are labelled by convention clockwise from left, bottom corner, eg. area LIHM.
[3] The effective supply curve indicates production from the lowest-cost producers, inclusive of the tariff.

The decline in domestic production from Oq_2 to Oq_1 contributed an increase of q_1q_2 to imports. Previously produced domestically, after the formation of the union q_1q_2 is imported from P at a lower cost. This yields the trade-creating welfare gain of JEI. The rise in consumption from Oq_3 to Oq_4 lead to a rise of q_3q_4 in imports, resulting in an increase to consumer surplus of HFG.

These welfare gains must be weighed against welfare losses due to trade diversion. Prior to the formation of the union, q_2q_3 was imported from W, the lowest-cost producer, at a tariff-exclusive cost of q_2LMq_3 - the cost to consumers being q_2EFq_3. Now, q_2q_3 is sourced from the customs union partner P at a cost of q_2IHq_3. Area IEFH represents merely a transfer of tariff revenue back to consumers. The remaining area LIHM represents the loss of tariff revenue to the government as a result of diverting imports q_2q_3 from the lowest-cost producer W to the customs union partner P.

Accordingly, the welfare gains due to trade creation (JEI + HFG) need to be compared to the welfare losses of LIHM due to trade diversion. Net gains resulting from the formation of a customs union between H and P are therefore an empirical question dependant on the relative magnitude of trade creation and trade diversion[4] (El-Agraa, 1985).

[4]If the initial price prior to the formation of a customs union between H and P is given by the intersection of D_H and S_H, due to the imposition of a higher tariff, the union will lead to pure trade creation. On the other hand, if the initial price due to a lower tariff, is OC, then the union will result in pure trade diversion. The relative magnitudes of trade creation and trade diversion, and hence net economic gains, therefore depend on the price elasticities of S_H and S_U, and D_H and the difference in cost between the lowest-cost producer, W and the customs union partner, P (i.e. the divergence between S_W and S_U) El-Agraa, 1990).

Appendix 3

The Cooper - Massell critique

With reference to Figure 1, the Vinerian analysis of trade creation and trade diversion, Cooper and Massell (1965 in El-Agraa, 1990) assert that if tariffs are unilaterally reduced for W and P to AC, yielding an equilibrium price OC at the intersection of D_H and S_U, the ensuing formation of a customs union between H and P results in trade creation without trade diversion, as the effective supply curve facing H is now BJGU.

Under this scenario, imports q_2q_3 are still purchased from W, the lowest-cost producer, at a cost of q_2LMq_3, as the tariff-inclusive price of imports from W equals the price of imports from P, the customs union partner. In addition, the new imports of q_1q_2 and q_3q_4 are also sourced from W, generating a tariff revenue of KJIL + MHGN. The customs union is therefore obsolete, and Cooper and Massell conclude that a policy of unilateral tariff reduction is superior to that of customs union formation (El-Agraa, 1990).

Appendix 4

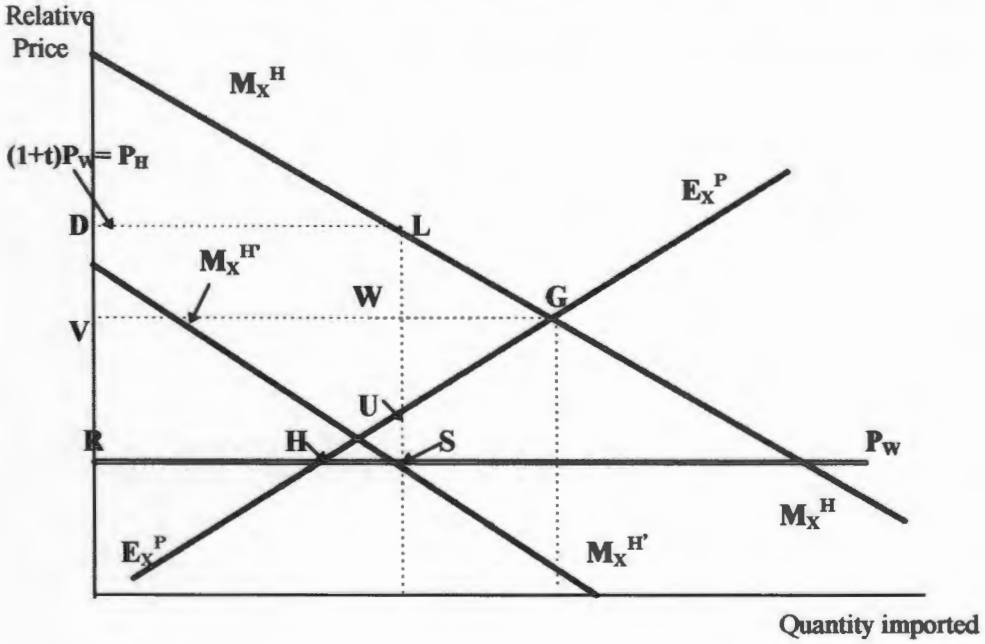
Static Analysis of a Free Trade Area

Static analysis of an FTA assumes:

- a two-goods, three-country model - H represents the home country, P the potential partner country in an FTA, and W the rest of the world.
- two possible scenarios: 1. H and P import the same good;
  2. H and P import different goods.

When H and P import the same good from W, there is no trade between them prior to forming an FTA. If the formation of an FTA does not change the tariff on W, there will be no change to the initial equilibrium, and the FTA will be void. Many integrating schemes among developing countries, particularly in Africa, have failed precisely because the countries had similar trade patterns and attempts at integration have had little impact.

Figure 2 **Trade Creation and Trade Diversion in a Free Trade Area**



Source: De Melo et al, 1994

When integrating partners H and P import different goods, assume that:

- the home country H imports good X, and the partner country P exports good X;
- only the home country H levies tariffs.

In Figure 2, M_X^H and E_X^P are the general equilibrium import and export demand curves of H and P respectively. P_W represents the free trade price of good X at which the rest of the world (W) trades. Starting from a position of autarky, relative prices of X in H and P are given by the respective heights of the curves M_X^H and E_X^P at their points of origin.

Under free trade conditions, the gains to H are represented by the area *below* the import demand curve and *above* the world price line P_W, and the gains to P by the area *above* the export supply curve and *below* the world price line.

Assuming that due to discrepancies between private and social costs, the home country H initially levels a tariff (t_H) on all imports from P and W. The import demand curve as *perceived* by P and W shifts to $M_X^{H'}$. The perceived import demand curve, $M_X^{H'}$, lies below the original import demand curve, M_X^H, by the amount of the tariff t_H.

The home country H imports RS of good X - RH from partner country P and HS from the lowest-cost producer in the rest of the world W - at price P_W. The domestic price in H is given by $P_H (=[1+t]P_W)$ - the height of the import demand curve as perceived by the home country's residents.

The gains from trade for the home country H are given by area DM_X^HL in addition to the tariff revenue RDLS received, whilst P gains area E_X^PRH.

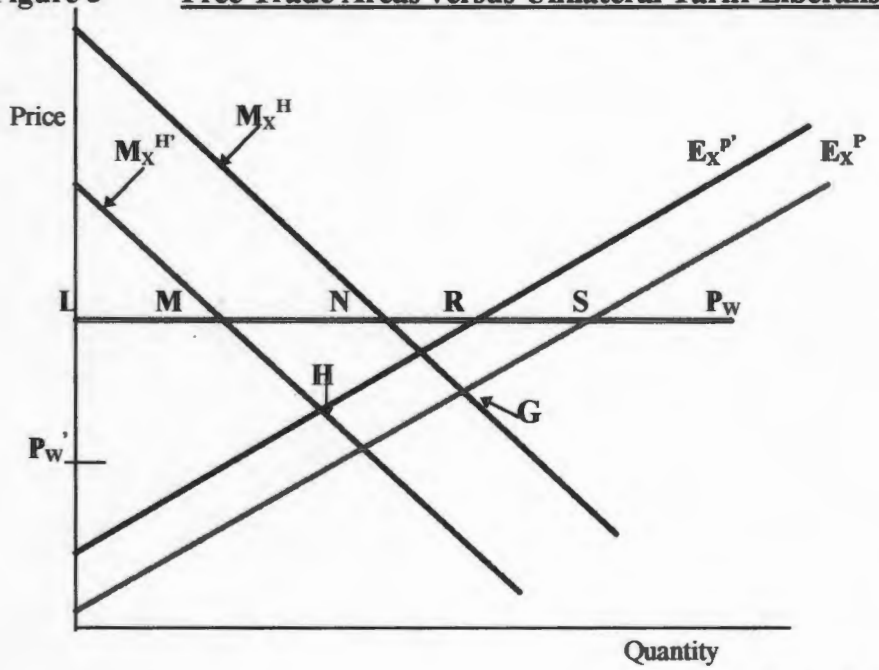
H and P now form a free trade area, causing all imports to the home country H to be diverted from the lowest-cost producer in the rest of the world W, to the partner country P. The FTA benefits the partner country P as its terms of trade improve and its exports expand (net gain to P given by area RVGH). However, the net gain to the home country H is ambiguous as its terms of trade deteriorate, but the distortion between its domestic price and the new union border price is

eliminated. Consequently, the home country H gains or loses depending on the relative magnitudes of trade diversion (area RVWS) due to lost tariff revenue and trade creation (area WLG).

Appendix 5

As seen in Figure 2, the home country's welfare is maximised by pursuing a policy of unilateral tariff liberalisation. However, this analysis assumes that the partner country did not levy tariffs on the good X. Assume now that the free trade agreement is negotiated from an initial position where both H and P levy tariffs on good X. That is, the free trade agreement obtains market access for H for X in the partner country P. This may yield a result where a free trade agreement is preferred to that of unilateral tariff liberalisation, but only where the partner country is willing to accept a sub-optimal position due to political or strategic reasons.

Figure 3 **Free Trade Areas versus Unilateral Tariff Liberalisation**



Source: De Melo et al, 1994

Figure 3 illustrates:

- the free trade general equilibrium import demand curve (M_X^H) of the home country H and the general equilibrium export supply curve (E_X^H) of the potential partner country P *prior* to the formation of a free trade agreement;
- P_W, the supply price of the lowest-cost producer of the particular commodity in the rest of the world.

- the introduction of tariffs by both H and P on good X before integration - this leads to a shift of both the import demand curve of H and the export supply curve of P as *perceived* by each other and the rest of the world to $M_X^{H'}$ and $E_X^{P'}$, respectively.
- H and P trade good X at the world price P_W - H importing quantity LM and P exporting quantity LR.
- The gains from trade for the home country H are measured by the area enclosed by M_X^H, the world price line P_W, and the quantity traded, and for the partner country P by the area enclosed by E_X^P, P_W and quantity traded.

If H undertakes unilateral tariff reduction, its imports will increase to LN and its welfare rises. In contrast, if H and P form a free trade area, the new equilibrium will rest at G, yielding a greater benefit for the home country. However, the partner country *loses*.

Compared to equilibrium at G, the partner country could improve its own welfare by undertaking non-preferential unilateral tariff liberalisation, yielding an equilibrium point of S. A free trade area would be preferable to unilateral trade liberalisation if the home country H could adequately compensate the partner country for the loss of welfare due to the formation of a free trade area. However, required compensation exceeds the H's gains from the free trade area by area GNS. Consequently, the formation of a free trade area between H and P would be preferable to unilateral trade liberalisation only in the case where P chooses to accept a suboptimal welfare position due to strategic or political reasons.

Introducing third country tariffs, suppose that W levies a tariff on good X. If W is a buyer of good X in the world market, it will offer a price lower than its internal price for X. On the other hand, if W is a seller of X on the world market, it will demand a price higher than its internal price.

In Figure 3 suppose that W's selling price is P_W, its buying price is P_W', and its internal price lies between P_W and P_W'.

This means that the partner country P cannot trade at R, exporting LM to the home country and MR to the rest of the world, as the world's buying price for the good is P_W', lower than the terms offered by the home country. Similarly, for the

home country the terms offered by the partner country P at point H will be better than the selling price P_W, offered by the rest of the world W. Consequently, H and P will trade at point H.

If the home country and the partner country then form a free trade area, eliminating tariff barriers between themselves, they can trade at point G, and both do better off than if either one were to unilaterally lower tariffs. An FTA in this case is superior to unilateral tariff liberalisation by either country (De Melo et al, 1994).

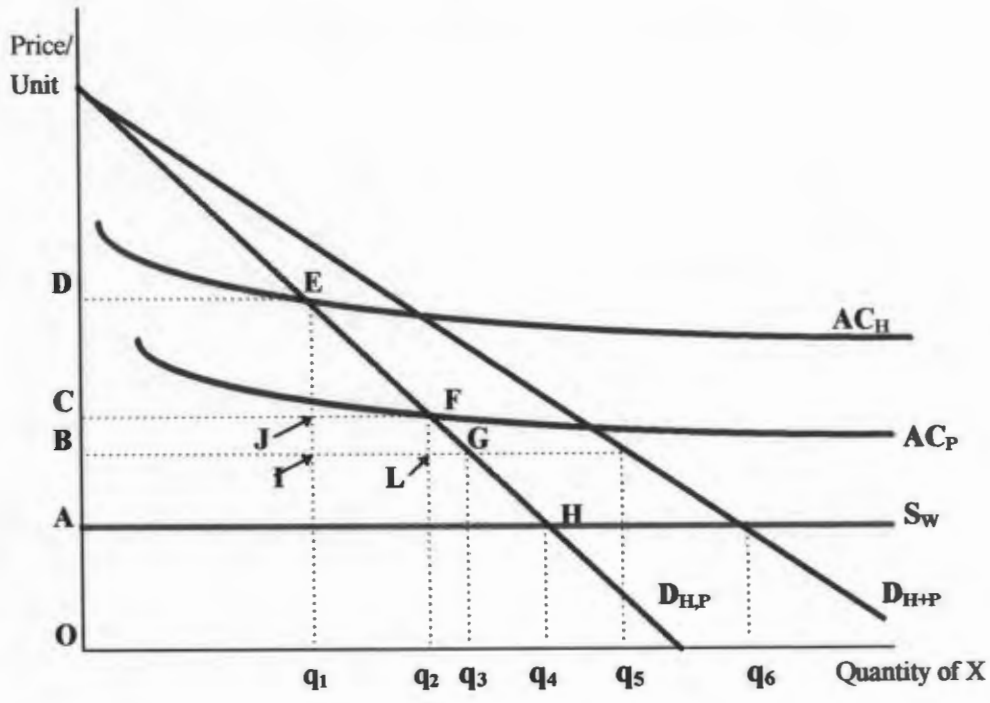
Appendix 6

Figure 4 depicts the formation of a customs union when decreasing costs are assumed[5].

Analysis assumes that:

- identical demand conditions prevail in both the home country H and the potential customs union partner country P as delineated by $D_{H,P}$ - the identical demand curve for both H and P;
- D_{H+P} is the joint demand curve for the customs union formed by H and P;
- S_W is the world's supply curve; and
- AC_H and AC_P are the average cost curves for H and P, respectively, depicting decreasing costs[6].

Figure 4 Scale Economies and Customs Union Formation



Source: El-Agraa, 1990

[5] Note that all assumptions previously held under the Vinerian analysis of customs union formation still apply, except that decreasing costs are now assumed.

[6] It is clear from Figure 4 that the home country is a higher-cost producer of good X than P, the potential customs union partner.

Pareto optimality in this analysis is represented by the free trade scenario - the intersection of D_{H+P} and S_W, the lowest-cost producer, yielding an equilibrium price OA and quantity q_6. If H and P then exact tariffs[7] AD and AC on good X respectively due to a discrepancy between private and social costs, the home country H will produce q_1 at price AD, and the potential partner country P will produce q_2 at price OC.

When H and P form a customs union, only the lowest-cost producer P will supply the union with q_5 at price OB. Demand in both H and P increases to q_3, resulting in gains of BDEG for H and BCFG for P. These gains are due to both the trade creation and cost reduction effects of customs union formation. Trade creation yields gains IEG and LFG for the home country H and the partner country P respectively, whilst the cost reduction effect renders BDEI for H and BCFL for the partner country P due to the exploitation of economies of scale. These gains must be compared against the loss of producer surplus for H and the gain of producer surplus for P in order to assess net gains[8] (El-Agraa, 1990).

[7] The optimal tariff would be a 'made-to-measure' tariff, defined by Corden (1972) to be that which induces an increase in domestic production to the level which just meets domestic demand without permitting the collection of monopoly rents.

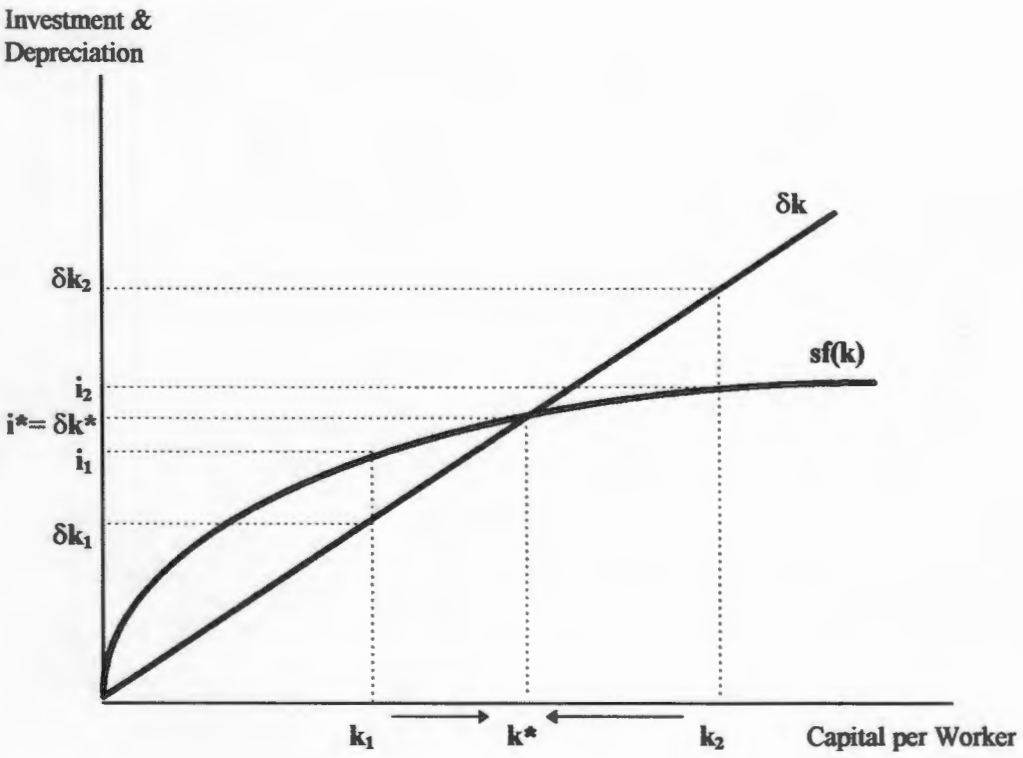
[8] Analysis of net gains requires the consideration of producer surplus. Figure 4 excludes supply curves for simplicity, and therefore producer surpluses for H and P are not quantified in this analysis.

Appendix 7

Neoclassical growth theory, based on the Solow model, facilitates understanding of how technological, physical and human capital accumulation impact on the growth of output. The Solow model assumes:

- a fixed investment:output coefficient;
- investment is domestically sourced;
- a Cobb Douglas production function of the form $Y_t = F(K,L) = A_t K_t^{a} L^{1-a}$; (K = physical capital, L = Labour, A = factor productivity (identical to human capital/ labour productivity) which implies constant returns to scale (CRTS). CRTS means that output per worker depends only on the amount of capital per worker. Therefore the production function can be expressed in per capita terms as: $y_t = f(k)$, where y_t = per capita output, and k = amount of capital per worker (K/L);capital stock depreciates at a constant annual rate = δ and is therefore proportional to capital stock.

Figure 5 Investment, Depreciation and the Steady State - The Solow Model



Source: Mankiw, 1992

Changes to the capital stock occur through new investment or that investment which replaces worn-out (depreciated) equipment. A steady-state (at $i^*=\delta k^*$) is reached when the amount of investment in an economy exactly balances the amount of depreciation of capital equipment. At this point, there is no force inducing a change to the capital stock.

In the Solow model, the steady-state represents the long-run equilibrium of the economy. Per capita levels of capital stock k below that of the steady state (i.e. k_1) will result in investment greater than depreciation, and a growth of capital stock. Levels above that of the steady state (i.e. k_2) will yield rates of depreciation greater than investment, and a decline in the capital stock. When the rate of investment exactly equals that of depreciation, the economy is at a long-run steady-state.

The Solow model concludes that:

- the savings rate is a key determinant to economic growth, assuming that the level of domestic savings determines the level of domestic investment. If the savings level is high, the capital stock will be greater, yielding higher per capita growth of income. However, policies to increase the rate of savings will only induce higher growth in the short run, until the steady-state is reached.

- the inclusion of population growth explains a persistent increase in *total output* which will increase at the same *rate* as the population, but it does not clarify why *per capita* incomes, and thus living standards increase.

- the incorporation of *exogenous* technological progress yields further growth to total income due to rising labour productivity . It is this factor which explains the persistent increase in living standards in the international economy (Mankiw, 1992).

The Solow model has been acknowledged as a credible foundation to growth theory, but has been attacked on its lack of applicability to empirical data. Although the model predicts the *direction* of capital accumulation in response to changes in the savings and population growth rates, it cannot predict the *magnitude* of such change. Mankiw et al (1992) argue that the Solow model is consistent with empirical data if it is augmented to take into account the accumulation of human as well as physical capital. The inclusion of human capital accumulation goes some way to explaining why the Solow model appears to *over-predict* the influence of savings and population growth on capital accumulation.

Appendix 8

Table 5 Policy-Relevant South African Exports to the EU

Product Description	1993 exports Ecu '000
Aluminium, not alloyed, unwrought	5,671
Frozen monkfish	3,258
Phosphoric acid and polyphosphoric acids	12,332
Vanadium oxides and hydroxides	6,370
Mimosa extract	7,228
Apples, fresh, from 1 April to 31 July (excl. Granny Smith and Golden Delicious)	11,270
Golden Delicious, fresh, from 1 April to 31 July	25,459
Granny Smiths, fresh, from 1 April to 31 July	31,021
Frozen hake	20,428
Frozen squid	9,445
Pears, prepared or preserved	6,845
Fresh or dried avocados, from 1 June to 30 Nov.	17,094
Fresh navels, from 16 May to 15 Oct.	50,798
Fresh flowers, from 1 November to 31 May	3,508
Granny Smiths, fresh, from 1 Aug. to 31 Dec.	4,641
Other vegetables, uncooked or cooked by steaming or boiling, frozen	6,473
Fresh sweet oranges, from 16 May to 15 Oct.	3,520
Fresh pears, from 1 Jan. to 31 March	11,582
Men's/ boy's suits of wool or fine animal hair, woven, etc.	5,321
Fresh melons, excl. watermelons	3,880
Mixtures of fruits, prepared or preserved	12,925
Fresh pears, from 1 April to 15 July	36,775
Pineapple juice	3,097
Fresh plums, from 1 Oct. to 30 June	10,693
Fresh table grapes, from 1 Nov. to 14 July	75,439
Squid, frozen	5,481
Peaches, prepared or preserved	9,602
Frozen fillets of hake	13,416
Sacks and bags of polymers of ethylene	4,138
Silicon	29,339
Apricots, prepared or preserved (sugar content greater than 15%)	3,915
Apricots, prepared or preserved (sugar content greater than 13%)	3,208
Fresh or tried tangelos, ortaniques, malaqunias, and similar citrus hybrids, etc.	3,172
Men's/ boy's trousers/ breeches of cotton denim, woven, etc.	4,394

Wine of fresh grapes, incl. fortified wine (alcohol content less than 13%)	4,394
White wine of fresh grapes (alcohol content less than 13%)	10, 438
Men's/boys' trouser/ breaches of synthetic fibres, woven etc.	4,382
Maganese dioxide	4,177
Fresh or dried clementines	3,474
Baths, showers and washbasins, of plastics	3,801
Doors, windows and their frames and thresholds for doors, of aluminium	5,325
Dried sweet peppers (excl. crushed or ground)	3,577
Crushed or ground fruits of genus Capsicum or Pimenta	3,738
Television receivers, colour, without screen etc.	4,314
Video tuners	3,671
Totals	**517,192**

Source: Stevens and Kennan (1995)

Table 6 **Intra-EU Trade in South Africa's Policy Relevant Items (1993)**

Member State	Share of 45 items in total intra-EU exports (percentage)	No. of significant export items	Share of significant items in total intra-EU exports (percentage)
Greece	3.5	6	3.25
Spain	2.6	3	1.85
Portugal	1.6	4	1.40
Netherlands	1.5	3	0.88
Belgium/Luxembourg	1.2	3	0.78
Italy	1.0	1	0.37
France	0.6	1	0.11
Denmark	0.4	2	0.35
UK	0.4	2	0.24
Germany	0.3	-	-
Ireland	0.2	-	-

Source: Stevens and Kennan, 1995

Table 7 **Policy-Relevant EU Exports to South Africa**

Product Description	1993 Imports Ecu '000
Meat and edible meat offal	14,735
Aircraft, spacecraft and parts thereof	42,379
Man-made staple fibres	11,106
Beverages, spirits and vinegar	52,698
Soap, organic surface-active agents, artificial waxes, etc.	13,141
Plastics and articles thereof	88,623
Products of animal origin, nesoi	7,585
Precious/ semi-precious stones, precious metals	51,116
Wadding, felt and non-wovens	7,777
Tanning or dyeing extracts	31,309
Paper and paperboard	62,563
Essential oils; perfumery, cosmetic, or toilet preparations	26,338
Miscellaneous chemical products	63,164
Cork and articles thereof	6,036
Products of the milling industry	154,809
Ceramic products	21,837
Articles of iron or steel	10,036
Nuclear reactors, boilers, machinery/ appliances, etc.	745,285
Photographic or cinematic goods	8,431
Printed books, newspapers, etc.	56,620
Rubber and articles thereof	17,416
Precision, medical, optical, etc., instruments	76,393
Vehicles other than railway or tramway rolling stock	216,314
Pharmaceutical products	103,276
Organic chemicals	47,657
Electrical machinery and equipment	227,392
Raw hides and skins, and leather	6,975
Animal or vegetable fats or oils	11,124
Ships, boats and floating structures	14,782
Mineral fuels and oils, bituminous substances	6,661
Totals	**2,064,578**

Source: Stevens and Kennan (1995)

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