

# trade hot topics

## Road to Single Market and Economy: Issues to Consider

Robert Scollay\*

### Background

The ambition of groups of developing countries to achieve greater economic integration among themselves often finds expression in decisions to pursue the establishment of a 'single market' or 'single market and economy' (SME). Recently, ministers of the fourteen independent Pacific Island countries (PICs) mandated a pre-feasibility study on a possible Pacific Single Market and Economy (PSME). An important part of this study was a survey of similar initiatives around the world. This issue of *Commonwealth Trade Hot Topics* highlights some of the key issues emanating from it with implications for regional integration towards an SME among groups of small developing countries.

### Integration and single market

The essential concept of SME is perhaps well understood. The purpose of a single market is to integrate goods, services, labour and capital across the member countries. Such a transformation requires harmonising a range of economic policies, with attention most often being focused on the establishment or adoption of a common currency. The design of single markets or SMEs is always highly complex, comprised of many different

elements. In every existing initiative the establishment of a single market or SME has been a very lengthy process, which furthermore is still incomplete in every case. The time required to establish a single market or SME must be measured in decades rather than years.

### Trade in goods

In the great majority of initiatives, progress towards establishment of a single market has commenced with measures to liberalise trade in goods between the members. The process of liberalising trade in goods has often been under way for a considerable period before the beginning of meaningful efforts to liberalise services trade and movements of capital and labour. The timing and sequencing of these later steps tends to be more variable, depending on the circumstances and sensitivities of the countries involved.

Achievement of an integration arrangement often proceeds initially in a cautious, hesitant, even piecemeal fashion. At initial stages, stakeholders remain ambivalent about the merits of integration. Nevertheless the decision to proceed with complete or near-complete liberalisation has to be made if the integration process is to achieve real momentum and credibility. In principle a single

\* The author is Associate Professor and Director of the APEC Study Centre at the University of Auckland in New Zealand. This article is an outgrowth of a study that the author prepared for the Commonwealth Secretariat. The views expressed here are those of the author and do not necessarily represent those of the Commonwealth Secretariat.

## Box 1: Regional integration processes

It is conventional to recognise five levels of integration schemes towards a SME. It is, however, not necessary for a group of countries to move sequentially from one level to the next.

1. **Preferential trading arrangements:** It is the simplest form of economic integration. It requires only that participating countries grant each other preferential (but not necessarily free) access to each others' markets.
2. **Free trade area (FTA):** Under this arrangement both tariffs and quantitative restrictions are abolished among member countries but they retain their own external tariffs (on imports from outside the FTA). Differences in external tariff rates generally make it necessary to impose rules of origin (ROO) requirements on intra-group trade.

3. **Customs union (CU):** At a minimum this generally requires a Common External Tariff (CET) on imports from non-members and no import tariffs on trade between members. CUs are also assumed, normally, to involve the same abolition of internal tariffs and quantitative restrictions as in an FTA and, as such, to be 'the next step'.
4. **Common market,** which is a CU that allows the free movement of capital and labour among members and a harmonisation of trading standards and practices, together with a common trade policy towards third parties which goes beyond simply a CET.
5. **Economic union,** in which the members of a common market also harmonise their economic policies, including some co-ordination of monetary and fiscal policies, and also transportation and competition policies.

market should incorporate a customs union with a common external tariff, but in practice reaching agreement on it for countries with divergent tariff structures can be a difficult and divisive process.

Removal of tariff barriers will generally be accompanied or followed by a realisation that many other impediments also need to be removed before goods can flow freely between the member countries. Streamlining of customs and quarantine procedures and deregulation of transport links is an obvious step, but the concept of a single or common market requires deeper integration than this. It implies that goods should be bought and sold in each member country under conditions as closely equivalent as possible, which should be reflected in the convergence of prices across the single or common market, after allowing for irreducible differences in transport costs. This in turn implies the need for a number of further steps beyond those required in a customs union:

- Removal of regulatory differences between the treatments of the same good produced domestically and produced in other member countries
- Removal of differences in standards so that regulatory differences do not impede trade. This is achieved by either harmonisation or mutual recognition of national standards

- Removal by each member country of discrimination in their government purchasing arrangements against the products of other member countries
- Adoption of common approaches to the various forms of intellectual property protection
- Closer alignment, if not outright harmonisation of indirect taxes on goods, such as value added taxes, sales taxes and other forms of consumption tax

## Trade in services

Liberalisation of services trade is always a slow and complicated process. This is due to a number of factors including the nature of barriers, the sensitivity and complexity surrounding certain regulations, the large variety of service sectors and the considerations involved in the choice of a modality to carry out services trade liberalisation.

The logic of a single or common market implies that services, like goods, should be supplied and consumed in each member country under conditions as closely equivalent as possible. Therefore, differences in regulations applying to service providers in different member countries should either be eliminated, if possible, for all sectors and all modes of supply, or there should mutual recognition of standards, qualification

requirements and accreditation institutions so that these regulatory differences do not interfere with trade flows. This has however never been fully achieved in practice, due in part to the strength of residual sensitivities and in part to the sheer complexity of the tasks involved. Even in the European Union, which originally targeted completion of its single market by 1992, establishment of a single market for services remains a work in progress.

### **Integration of capital markets**

Integration of capital markets within a single market is an essential element in the creation of a unified economic area. It involves freeing up of both foreign direct investment and portfolio capital movements, and it is necessarily intimately connected with the integration of financial markets. This step will often be understandably viewed as problematic by developing countries. One reason will typically be that development of their capital markets remains at a relatively rudimentary stage, with limited capacity for effective supervision and governance. Another reason will often be that flows among the partners represent only a small fraction of the flows of capital in and out of each partner, with traditional developed country partners accounting for the largest share of these flows.

### **Movement of labour**

In a single market or common market movement of labour should in principle involve the ability to move and work freely anywhere within the member countries. In practice, political and economic sensitivities often mean that the full mobility of labour will be introduced gradually even within single or common markets. Mobility of skilled labour generally comes first, and requires that issues relating to recognition of occupational qualifications and certification are addressed. Full mobility for unskilled labour will generally be the last element to be introduced. Even when labour mobility has been established in a formal sense, significant impediments will typically remain, for example, restrictive labour market regulations, limited access to social security arrangements, and non-portability of pensions. These issues take much time, effort and political will to resolve.

### **Economic benefits and challenges of an SME**

There are analytical and empirical grounds that the economic benefits for a regional grouping from the increased intra-regional flows of goods, services,

capital and labour under an SME will be greater than the economic benefits from increased intra-regional trade flows under an FTA. For groups of small developing countries the size of these economic benefits may nevertheless be modest, since they are likely to be commensurate with the size of the effects on intra-regional flows of goods, services, capital and labour, which are likely to remain a relatively small part of the total international flows of the countries concerned, even after the SME is in place.

There is wide variation across the many different integration initiatives in the sequencing within the overall process of integration of the steps towards the adoption of common economic policies and institutions that characterise a single market. In some cases these steps, especially the move to a monetary union, are consciously planned as a further phase of integration to be built on the achievement of a single market. In other cases these steps seem to emerge more organically, as growing economic interdependence leads to an increasing recognition that economic policies in one member country can have significant contagion effects on other members. Historically, the experience of regional economic crises has often been effective in driving home recognition of these points. The upshot will be greater acceptance of the need for closer co-ordination of macroeconomic policies, to be promoted at a minimum through increased consultation and dialogue between policy-makers and policy institutions, and perhaps also through the introduction of some kind of macroeconomic surveillance mechanism.

These variations in sequencing are clearly in evidence in the timing of steps towards a monetary union. In what might be termed the 'classic' sequence, monetary and wider macroeconomic policy integration is regarded as the final culminating stage of economic integration. This is consistent with the view that monetary integration is an element of the economic integration process that becomes both feasible and desirable when the integration process reaches an advanced stage.

In other cases monetary integration is introduced much earlier for varying reasons. Cases where monetary integration occurs at a relatively early stage typically involve smaller economies seeking to import some of the benefits associated with the strong currency of a larger neighbour or economic partner, either by outright adoption of the strong

currency or by establishing a credible fixed parity with it. The benefits may include stronger monetary policy discipline, leading to greater monetary stability and enhanced control over inflation, and lower international transactions costs. An example would be the adoption of the South African currency by the smaller members of the Southern African Customs Union (SACU). In the case of the Pacific Island Countries (PICs) there have been suggestions that they should adopt the Australian dollar, or perhaps the United States dollar. In such cases, where the principal purpose of monetary union is to benefit from the strength of the currency being adopted, there is arguably no reason to delay monetary integration until a late stage of the overall economic integration process.

Linking local currencies to a strong external currency does not, however, automatically ensure macroeconomic discipline and stability. It is possible that institutional arrangements surrounding the currency linkage may allow the developing country partners to evade the discipline that would otherwise be imposed, as appears to have been the case in the African franc zone. On the other hand the Organisation of Eastern Caribbean States (OECS) provides a counter-example of a common currency that appears to operate for the most part successfully, and might have contributed to encouraging cross-border investment and trade through reduced transaction costs. The OECS appears to be an example where the creation of a single economic space has facilitated the free movement of people, goods, services and capital, leading to economic diversification and growth, greater export competitiveness, and more employment and human resource development.

The OECS provides an example of how deeper integration can create opportunities to economise on resources by regionalising some policy functions, both at the policy advice stage and at the implementation stage. Examples include the Eastern Caribbean Civil Aviation Authority which advises the governments of the OECS on all matters relating to civil aviation including airfields and airport developments, the implementation of ICAO conventions and the adequacy of air services. The Eastern Caribbean Supreme Court is the superior court of record for the OECS members. The OECS has also established the Eastern Caribbean Telecommunications Authority (ECTEL), responsible for setting regulatory policy and providing management guidance for the telecommunications

sector in the OECS states. Another OECS initiative of particular interest is its Pharmaceutical Procurement Service (PPS), which pools procurement of pharmaceuticals and medical supplies for nine ministries of health in OECS members and associates. The PPS acts as a self-financing buyers' cartel, covering its costs from a 15 per cent surcharge on purchases made. It claims to have achieved savings of up to 44 per cent over prices paid by individual countries. In the PICs case, there is also interest in establishing Pacific regional purchasing arrangements for petroleum products.

It is of course possible to consider the establishment of such initiatives on an individual basis, without an overall commitment to an SME. An SME however provides a coherent organising framework for the different elements of integration, and helps to make clear the connections between them, so that the case for their introduction as part of an SME becomes more compelling than the case for their separate introduction as isolated initiatives. Adoption of an SME programme also provides the basis for a forward agenda against which progress can be monitored and measured. The experiences of many SME initiatives indicate that a coherent agenda stretching at least into the medium term is essential to the successful pursuit of deeper integration. Checklists of actions that member states must undertake in order to implement agreed single market or SME provisions can be a useful monitoring tool.

At the same time experience also suggests the importance of ensuring that the forward agenda consists of manageable steps that are clearly seen to deliver concrete benefits to businesses and communities, as well as deepening the process of integration. Elaborate plans that lack a clear practical rationale are likely to wither for lack of political support.

Institutional development should proceed in parallel with the integration process, responding to the requirements of deepening integration as they arise. Elaborate institutional development that runs ahead of the needs of the integration process is likely to result in dysfunctional institutions and large-scale waste of resources, undermining the credibility of the integration agenda. The subsequent revisions of the legal framework that would be required to undertake in such cases can be slow and cumbersome processes significantly retarding progress towards SME.

## Institutional issues

A key choice in the design of economic integration initiatives is whether to rely entirely on intergovernmental arrangements or to introduce elements of supranationality. In intergovernmental arrangements, governments reach agreement on the adoption of certain policies or commitments, but implementation and enforcement of those policies and commitments is left entirely in the hands of the national governments and their institutions. Supranationality, on the other hand, means that responsibility for some elements of implementation and enforcement has been handed over to supranational institutions such as the European Commission or European Court of Justice in the European Union. While attitudes and sensitivities towards sovereignty will clearly be important in this choice, it also has to be recognised that some surrender of sovereignty occurs even in intergovernmental arrangements, since these involve binding commitments by governments to adopt certain policies and to limit their freedom to change those policies or adopt new policies, and these commitments may in turn be enforceable through dispute settlement.

## Conclusion

Examination of existing integration initiatives indicates that the initial choice between supranational and intergovernmental approaches is not necessarily a critical determinant of success or failure, since there are successful and unsuccessful examples of both approaches. Deepening integration does however eventually raise questions of legal authority and political legitimacy that sooner or later may force consideration of the establishment of supranational institutions. There is no doubt that adoption of a common currency, with its requirement for a common monetary policy, marks a point at which acceptance of some degree of supranationality becomes indispensable.

Ultimately one of the most important functions of a single market or SME among developing countries may be to equip them, in terms of both policy settings and regional institutional development, to successfully engage in integration with larger partners in their surrounding region and beyond. The Association of Southeast Asian Nations (ASEAN) is a case in point. ASEAN has been engaged in a lengthy process of integration within itself while concurrently pursuing integration through free trade agreements with surrounding economic powers such as China, Japan, South Korea, India,

and Australia and New Zealand. Similar proposals have been under development for integration across the entire East Asian or Asia—Pacific regions. ASEAN concluded that in order to successfully engage in these region-wide integration initiatives it will have to deepen its own internal integration. The result has been a commitment to establish a single market, the ASEAN Economic Community (AEC), by 2015.

Groups of much smaller developing countries, such as the Pacific Island Countries, face in even more acute form the challenge of deepening their integration with larger economic partners. Establishment of a single market or SME may be an important and even necessary contribution to meeting this challenge.

# International Trade & Regional Co-operation Section at the Commonwealth Secretariat

This Trade Hot Topic is brought out by the International Trade and Regional Co-operation (ITRC) Section of the Economic Affairs Division (EAD) of the Commonwealth Secretariat, which is the main intergovernmental agency of the Commonwealth — an association of 54 independent states, comprising large and small, developed and developing, landlocked and island economies — facilitating consultation and co-operation among member governments and countries in the common interest of their peoples and in the promotion of international consensus-building.

ITRC is entrusted with the responsibilities of undertaking policy-oriented research and analysis on trade and development issues and providing informed inputs into the related discourses involving Commonwealth members. The ITRC approach is to scan the trade and development landscape for areas where orthodox approaches are ineffective or where there are public policy failures or gaps, and to seek heterodox approaches to address those. Its work plan is flexible to enable quick response to emerging issues in the international trading environment that impact particularly on two highly vulnerable Commonwealth constituencies — least developed countries (LDCs) and small states.

## Scope of ITRC Work

ITRC undertakes activities principally in three broad areas:

- It supports Commonwealth developing members in their negotiation of multilateral and regional trade agreements that promote development friendly outcomes, notably their economic growth through expanded trade.
- It conducts policy research and consultations increase understanding of the changing of the international trading environment and of policy options for successful adaptation.
- It contributes to the processes involving the multilateral and bilateral trade regimes that advance the more beneficial participation of Commonwealth developing country members, particularly small states and LDCs.

## ITRC Recent Activities

ITRC's most recent activities focus on assisting member states in the WTO Doha Round and the Economic Partnership Agreement (EPA) negotiations involving the African, Caribbean and Pacific countries (ACP) the European Union (EU), undertaking analytical research on a range of trade policy and development issues, and supporting workshops/dialogues for facilitating consensus-building on issues of Commonwealth members' interest, exchange of ideas, and disseminating results from informed analysis.

## Selected Recent Meetings/Workshops supported by ITRC

29 June - 01 July 2011: Regional Consultative Meeting on Procurement Development in the Pacific held in Brisbane, Australia

22-24 June 2011: ACP High Level Meeting in Preparation for the 3rd Global Review on Aid for Trade held in Geneva, Switzerland

16-June 2011: Consultation meeting on the Impact of the European Parliament Resolution on the Pacific EPAs, held in London, UK

13-14 June 2011: Meeting on Climate Change Mitigation and Safeguarding the Trading Interests of Small States and LDCs held in Hampshire, UK

31-May 2011: Export Group Consultation - Trade & Climate Change held in, London, UK

9-13 May 2011: Meeting and Symposium on LDC development events at the UN LDC IV Conference held in Istanbul, Turkey

5-6 May 2011: Trade Policy Seminar for Commonwealth Parliamentarians (Southern Africa) held in Livingstone, Zambia

12-13 April 2011: Workshop on Caribbean Public Procurement held in Montego Bay, Jamaica

11-April 2011: Expert Group Meeting on The UN LDC IV Conference and the Way Forward held in London, UK

6-8 April 2011: Roundtable on Competition Law and Policy held in, Boston, USA

28-29 March 2011: OECD workshop on Aid for Trade held in Paris, France

9 March 2011: Consultative Meeting on Trade Effects of Rules on Procurement for Commonwealth ACP members held in London, UK

## Selected ITRC Publications

Collier, P. (2011). *Catching Up: What LDCs Can Do, and How Others Can Help*, London: Commonwealth Secretariat.

Calì, M., Razzaque, M. A. and Te Velde, D. W. (2011). *Effectiveness of Aid for Trade in Small and Vulnerable Economies*, Economic Paper No. 91, London: Commonwealth Secretariat.

Calì, M with Kennan, J (2010). *The Global Financial Crisis and Trade Prospects in Small States*, Economic Paper, London: Commonwealth Secretariat.

Milner, C., Morrissey, O. and Zgovu, E. (2010). *Policy Responses to Trade Preference Erosion: Options for Developing Countries*. London: Commonwealth Secretariat.

Jones, E., Deere-Birkbeck, C. and Woods, N. (2009). *Maneuvering at the Margins: Constraints Faced by Small States in International Trade Negotiations*. London: Commonwealth Secretariat.

Razzaque, M. A. (ed) (2009). *Trade, Migration and Labour Mobility*. London: Cameron May.

Srinivasan, T N (2009). *LDCs, Landlocked Developing Countries and Small States in the Global Economic System*. London: Commonwealth Secretariat.

Stevens, C et al. (2009). *The CARIFORUM and Pacific ACP Economic Partnership Agreements: Challenges Ahead?*, Economic Paper No. 87, London: Commonwealth Secretariat.

Winters, L A et al. (2009). *An EU-India Free Trade Agreement: Reflections on the Implications for Excluded Countries*. London: Commonwealth Secretariat.

Calì, Massimiliano and te Velde, Dirk Willem (2008). *'Towards a Quantitative Assessment of Aid for Trade'*. Economic Paper, London: Commonwealth Secretariat.

Grynberg, Roman and Newton, Samantha (eds) (2008). *Commodity Prices and Development*. Oxford University Press.

Milner, Chris (2008). *Trading on Commonwealth Ties: A Review of the Structure of Commonwealth Trade and the Scope for Developing Linkages and Trade in the Commonwealth*. London: Commonwealth Secretariat.

Turner, L (2008). *'Quantifying Aid for Trade: A Case Study of Tanzania'*. Economic Paper, London: Commonwealth Secretariat.

Qalo, Veniana (ed) (2008). *Bilateralism and Development: Emerging Trade Patterns*. London: Cameron May.

Grynberg, Roman and Bilal, Sanoussi (eds) (2007). *Navigating New Waters: A Reader on ACP-EU Trade Negotiations*. London: Commonwealth Secretariat.

Razzaque, Mohammad A and Laurent, Edwin (eds) (2007). *Global Rice and Agricultural Trade Liberalisation: Poverty and Welfare Implications for South Asia*. London: Commonwealth Secretariat.

## Selected Ongoing Policy Research Projects

- Aid for trade in small states and Sub-Saharan Africa
- Trade and climate change issues for LDCs
- Rise of emerging developing countries and implications for Sub-Saharan Africa and small vulnerable economies (SVEs)
- Commonwealth Investment Framework Agreement
- Trade effects of Government Procurements on developing countries
- Development issues under EPAs
- Development aspects of trade-related issues and trade in services
- Regional trading arrangements in South Asia and their implications
- Trade in services issues for small states and low-income countries
- Fiscal implications of Pacific trading arrangements
- Issues in the context of the Fourth UN Conference on LDCs
- The development impact of the Doha Round on least developed countries (LDCs)
- The impact on small vulnerable economies (SVEs) of the Doha negotiations on agriculture, non-agricultural market access (NAMA), trade in services and development issues
- Non-tariff barriers in South Asia and Sub-Saharan Africa
- Textiles and clothing trade after the end of the Multi-fibre Arrangements
- Global value chains and the impact on growth in developing countries
- LDCs and SVEs in South-South trade



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For further information or to contribute to the Series, please email [m.razzaque@commonwealth.int](mailto:m.razzaque@commonwealth.int)