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Zambian Regional Integration Policy Challenges

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In this paper we analyse the challenges currently presented to Zambian regional policy. We conclude that (a) while Zambia should adopt the same tariff as other COMESA members, it should be cautious about losing its tariff-setting ability and accepting the legally binding obligations of customs union membership until the members of COMESA are able to remove their internal customs barriers. (b) Zambia should participate in the SADC as an FTA member but cannot belong to two customs unions unless they adopt the same external tariff. (c) Zambia's privileged position as a member of both SADC and COMESA will be eroded by a new Tripartite FTA. Its participation in that initiative therefore would only be beneficial if the agreement provides for improved trade facilitation, less restrictive rules of origin and other measures to reduce trade costs. Finally, (d) while initiatives to facilitate regional financial cooperation should be supported, monetary union at the regional level is not desirable for the foreseeable future.

Introduction

Zambia has positioned itself in a fairly favourable position with respect to its regional trade policy. As a member of both the Southern African Development Community (SADC) and Common Market for Eastern and Southern Africa (COMESA) Free Trade Areas (FTA) it is one of the few countries whose exports enjoy duty free access to African trading partners both to its north and south. At the same time, since SADC and COMESA are still Free Trade Agreements and since Zambia's World Trade Organization (WTO) commitments are not particularly constraining, Zambia enjoys considerable freedom to adjust its extra-regional tariffs and conduct its multilateral trade relationships as it sees fit.

But Zambia currently faces four major regional integration policy challenges: (i) the implementation of the COMESA Customs Union (CU) initially planned for June 2012, (ii) implementation of a SADC customs union, (ii) the Tripartite Free Trade Area negotiations involving SADC, COMESA and East Africa Community (EAC) members, and (iv) current discussions on the creation of a COMESA monetary union.

The most immediate challenge is the COMESA Customs Union that was scheduled to be concluded by June 2012. This is unlikely to happen on time, as the COMESA members have not yet implemented the required reforms.[1] Nevertheless, continued commitment to join the Customs Union by members at the ministerial level and the negotiation of new time-frames for implementation signal the intention by members to progress from the FTA to a CU.

Customs unions are recognized to have both costs and benefits when compared with free trade agreements. The costs come in the loss of flexibility to set external tariffs independently and thus the possibility that the common external tariff may not be optimal for each member. The benefits come from the ability to achieve deeper integration among the members, ideally by being able to remove the rules of origin and the internal customs posts between them.

Thus, the formation of the COMESA CU has important implications for Zambia. Since the common external tariff of COMESA will be set by consensus, Zambia will give up the flexibility to alter its tariffs with third countries. This means that, absent agreement by other members, it will lose the ability to offset the costs imposed by high-priced regional members that enjoy preferences by reducing external tariffs.

A COMESA CU could also create challenges for Zambia should the proposals for a SADC Customs Union come to fruition. Since customs union membership requires a common external tariff, it is not possible for a country to be a member of more than one such agreement. By contrast, countries can be members of several free trade agreements. Currently, therefore, Zambia has been able to negotiate joint membership in the COMESA and SADC free trade areas, but (unless both SADC and COMESA agree on a common external tariff) this position is not sustainable if the end-goals of forming both SADC and COMESA CU are to be achieved. Zambia therefore faces important choices with respect to its membership in each of these regional trade arrangements.

In principle, these costs in the loss of flexibility with respect to domestic policy space should be offset by the ability to eliminate rules of origin and internal customs. However, for the foreseeable future, while members of COMESA have agreed on a common external tariff they have not undertaken measures such as customs revenue sharing required to eliminate rules of origin. This means that customs revenue is still to be collected at final destination, postponing the full benefits of deeper integration and the elimination of internal customs to sometime in the future. (Although it is referred to as a "customs union", this is also the current situation in the EAC where revenues are collected at destination).

[1] After the launch of the CU in June 2009, a three year transition period was provided for members to: (i) align their national tariff rates to those under the CET (25% for final goods, 10% for intermediate goods and 0 percent for raw materials and capital goods), (ii) adopt the COMESA agreed trade nomenclature and (iii) domesticate the Customs Management Regulations. So far, none of the members have met all these requirements.

A third challenge is presented by the Tripartite Free Trade Area negotiations that aim to create a Cape to Cairo free trade area encompassing SADC, COMESA and the EAC. The interest in these negotiations is in part driven by the imperative of reconciling incompatibilities associated with the multiple and overlapping membership of African countries in the COMESA, SADC and EAC regional trade agreements.[2] There are also potentially large economic gains from integrating countries into an Africa-wide free trade area. However, as with all such agreements, the gains are not evenly distributed. The interests of countries differ and understanding how a Tripartite FTA will affect Zambia is necessary if Zambia is to formulate its negotiating position. This is especially the case since as we have noted, Zambia already has free trade agreements with all the Tripartite participants.

The final trade policy challenge, the creation of a COMESA monetary union, is not of immediate policy concern, but has major implications for how monetary and fiscal policy will be conducted in Zambia in the future if implemented. Rules governing the future implementation of a monetary union are currently being negotiated with other COMESA members. A clear understanding of the consequences of a monetary union for Zambia is necessary to direct policy makers' involvement in this process.

Zambia's responses and choices with respect to each policy challenge need to be shaped by its particular development needs and its geographic and geopolitical position. Zambia is a land-locked economy that is dependent on its neighbouring countries for access to the outside world. This imposes constraints on access to regional and foreign markets as well as imported goods. In addition Zambian trade faces high costs, partly because of Zambia's location and geography, but also because of some of its policies such as high fuels taxes, poor infrastructure, and inefficient border administration that leads to long delays.

High costs of engaging in international trade, raises costs of living and limit Zambia's ability to diversify into the production and export of manufacturing which is transport-intensive. Overcoming the constraints imposed by its geography is and, correctly, has been a central focus of the Zambian government's participation in the SADC and COMESA regional trade agreements.

A second consideration is Zambia's location between two regional trading blocks – the East African Community (EAC) and the South African Customs Union (SACU). These are relatively large and integrated markets that provide opportunities for Zambian business to export too, but also, given their relatively deep industrial bases (South Africa and Kenya) affect Zambian firm's competitive position in the region. Further, given Zambia's geographical position, these blocks are integral to the transport of Zambian goods to the rest of the world.

[2] For example, Tanzania is part of the EAC CU and the SADC FTA, but unlike the other EAC members is not a member of COMESA. Unless Tanzania joins COMESA, it will not be possible to create a fully fledged COMESA customs union with *free mobility of goods* across member's borders. Rules of origin restrictions and border controls will be required to ensure that goods from Tanzania do not freely enter into the non-EAC COMESA.

The third feature is Zambia's copper dependency. Copper exports account for close to 80 percent of total Zambian exports, a share that has risen since the early 2000s in response to both increases in the volume and price of copper exports.[3] Zambia's exports of non-traditional exports have also grown strongly (20% per year from 2000 to 2007), but were also adversely affected by the global financial crisis. Thus, Zambia's continued dependence on copper makes the macroeconomy vulnerable to fluctuations in the copper price. The diversification of the economy is therefore a central policy imperative.

These issues are well recognized in current policy initiatives, but they also need to feature centrally in Zambia's position with regards to the regional policy challenges it faces.

In this brief, we provide an evaluation of these challenges. First, we do believe that for political and economic considerations Zambia should join with other COMESA members in aligning their tariff to create a *de facto* common external tariff, but at this stage, we also believe that it would be unwise and premature to formalize this structure in a legally binding *de jure* customs union arrangement. The same would be true for a SADC customs union. The real benefits of a customs union that come from removing the internal customs borders between members and the elimination of rules of origin lie in the future, and only then may it make sense to give up the policy autonomy such an agreement requires. If it takes a long time before a full customs union with revenue sharing and the elimination of internal customs posts are achieved, Zambia would have given up policy autonomy without really obtaining additional benefits.

Second, with respect to the Tripartite negotiations, Zambia should bargain hard for trade facilitation benefits, such as rules of origin simplification, and improvements in infrastructure and customs and regulatory procedures to offset the loss of its unique position as a member of both SADC and COMESA. Unless these benefits are forthcoming, such an agreement could leave it worse off than it is today.

Third, there are benefits to the region from financial integration. In particular, having regional financial institutions such as banks provides economies of scale (such as reducing management overhead and spreading risks) and scope.(by being able to offer customers regional services). Thus regional cooperation on regulatory challenges should be the focus of the activities of regional monetary authorities. In addition cooperation on the exchange of information and peer reviews of macroeconomic policies could also be beneficial. However, Zambia should avoid the loss of monetary (and fiscal) policy independence entailed by full monetary union. Zambia in particular faces fiscal challenges that would make such a development premature.

[3] The price of copper rose more than fivefold from 2000 to mid-2008, but then collapsed during the financial crisis of 2008 & 2009. The copper price has subsequently recovered back to pre-crisis levels. The volume of copper exports rose from 337 000 tonnes in 2002 to 720 000 tonnes in 2010.

Box1: Five forms of economic integration

1. Preferential Trade Arrangement (PTA) which is the simplest form of economic integration; it requires only that participating countries grant each other some preferential (but not necessarily free) access to participants markets in some (but not necessarily substantially all) products.
2. Free Trade Area (FTA) in which both tariffs and quantitative restrictions (QRs) are abolished between member countries which, nonetheless, retain their own external tariffs (on imports from outside the FTA) and so do not have harmonised trade policies.
3. Customs Union (CU) in which members establish a common customs area. At a minimum this generally requires a common external tariff (CET) on imports from non-members and no import tariffs on trade among members. Fully fledged customs unions also share revenue and eliminate internal customs border posts.
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 practises, together with a common trade policy towards third parties that goes beyond simply a CET.
5. Economic Union in which the members of a common market also harmonise their economic policies including some coordination of monitory and fiscal policies, and also transportation and competition policies.
(DNA, 2007)

Where does Zambia currently stand?

Zambia is currently a member of both the COMESA FTA and the SADC FTA and has therefore positioned itself to enjoy duty free access into the major regional markets in the North and the South. In addition to market access, these FTA have created an institutional framework that has enabled participants to deal with cross-border trading constraints that are of paramount importance to Zambia, namely trade facilitation and regional infrastructure policies.

While regional tariffs affecting Zambia's intra-regional trade flows have largely been removed, trade remains restricted by complex rules of origin. This is particularly the case with SADC trade where rules of origin have been set at a product level basis. In contrast, relatively simpler rules of origin are imposed on intra-regional trade amongst COMESA members.[4]

Intra-regional trade flows are also severely constrained by high trade costs associated with weak regional infrastructure and, inefficient customs procedures. For example, it

[4] SADC has the most complex rules of origin of the Trilateral FTA group. It uses a line-by-line approach and uses a combination of specific processing requirements, changes in tariff classification and material content percentage tests. COMESA and EAC follow an across-the board basis for determining origin. See Naumann, R. (2011) Tripartite FTA State of Play on Preferential Rules of Origin, Tralac Trade Brief, March 2011.

takes Zambian firms on average 44 days and US$ 2 678 to export a standardized container of goods by ocean transport (Table 1). This includes the time associated with obtaining all documents, inland transport and handling, customs clearance and inspection and port and terminal handling, but excludes time and cost for ocean transport. This places Zambia 166th out of 183 countries surveyed in World Bank Doing Business Survey.[5]

The impact of these trade costs is extensive. High trade costs (including transport costs, time delays and transit times) reduce the volume of trade flows by existing exporters.[6] They also discourage entry of new firms into the export market and restrict access to new markets. These effects are most pronounced on manufactured exports, which often rely on access to cheap imported intermediate inputs. Trade costs, therefore, constrain the diversification of Zambia's export bundle in terms of new products, new markets and new exporters.

For Zambian firms, some of these constraints lie within the border and are associated with border administration (Zambia ranks 66th to 78th out of 125 countries in terms of efficiency of customs administration and transparency of border administration), poor transport and communications infrastructure (rank 114/125 countries), and internal transit delays. [7] But in many cases the delays and costs of transporting goods can be attributed to infrastructure and trade facilitation constraints outside of its border. Look, for example, at the World Economic Forum's (WEF) 2010 border administration and transport & communication infrastructure rankings (out of 125), respectively, of Zambia's neighbours through which its exports and imports transit: Zimbabwe 120 and 121, Tanzania 98 and 113, Namibia 89 and 90, Botswana 70 and 84, and finally South Africa 53 and 65.

The implication is that while improving border facilities and procedures and transport infrastructure within Zambia is important if exports are to be enhanced, it is not sufficient. Reducing the cost of trading for Zambian firms requires co-ordinated regional policies.

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[5] The World Bank Doing Business Indicators calculate the time and cost (excluding tariffs) associated with exporting and importing a standardized cargo of goods by ocean transport. This includes the time and cost associated with obtaining all documents, inland transport and handling, customs clearance and inspection and port and terminal handling. For exporting goods, procedures range from packing the goods into the container at the warehouse to their departure from the port of exit. For importing goods, procedures range from the vessel's arrival at the port of entry to the cargo's delivery at the warehouse. The time and cost for ocean transport are not included. (http://www.doingbusiness.org/methodology/trading-across-borders)

[6] See Djankov, S., Freund, C. and Pham, C.S. (2010) Trading on time. *The Review of Economics and Statistics*, 92(1), pp. 166-173.

[7] World Economic Forum Global Enabling Trade Report (2010). See Freund, C. and Rocha, N. (2011) (What constrains Africa's exports? *World Bank Economic Review*, 25(3), pp. 361-386) on the negative effect of transit delays on Africa's exports. For a trade and transport facilitation audit on Zambia see Meeuws, R. (2004) "Zambia – trade and transport facilitation audit", report prepared for World Bank (http://www.sadc.int/files/9713/2644/8955/Zambia_Transport_Sector_Study_WBank_2004.PDF)

Table 1: World Bank Trading across Borders information

	Documents to export (number)	Time to export (days)	Cost to export (US$ per container)	Documents to import (number)	Time to import (days)	Cost to import (US$ per container)
East Asia & Pacific	6	22	906	7	23	954
Eastern Europe & Central Asia	7	27	1,774	8	29	1,990
Latin America & Caribbean	6	18	1,257	7	20	1,546
Middle East & North Africa	6	20	1,057	8	24	1,238
OECD high income	4	10	1,032	5	11	1,085
South Asia	8	32	1,590	9	33	1,768
Sub-Saharan Africa	**8**	**31**	**1,960**	**8**	**37**	**2,502**
Zambia	6 (59)	44 (166)	2678 (166)	8 (98)	56 (169)	3315 (168)
Zimbabwe	8	53	3,280	9	73	5,101
Tanzania	6	18	1,255	6	24	1,430
Kenya	8	26	2,055	7	24	2,190
South Africa	8	30	1,531	8	32	1,795
Uganda	7	37	2,880	9	34	3,015
Mozambique	7	23	1,100	10	28	1,545
Mauritius	5	13	737	6	13	689
Swaziland	9	18	1,855	9	27	2,030
Congo, Dem. Rep.	8	44	3,055	9	63	3,285

Source: World Bank Doing Business indicators (http://www.doingbusiness.org/data/exploretopics/trading-across-borders)
Notes: Values in parentheses for Zambia reflect the rank out of 183 countries.

Zambia's participation in the SADC and COMESA FTA places constraints on its ability to set tariffs on intra-regional trade flows. However, policy makers retain substantial flexibility (policy space) to adjust multilateral tariffs (MFN tariffs). Zambia has bound its MFN rates, but at levels that far exceed its applied rates – bound rates under the WTO average 106.4 percent (with only 16.7 percent of tariff lines bound), whereas the average applied rate averages around 13 percent. Zambia has not made much use of this flexibility to raise tariffs, but it has made liberal use of non-standard exemptions on duties applied to imports.[8] These exemptions have applied particularly to imported intermediate inputs with the intention of reducing operating costs.

From a regional perspective, Zambia's current MFN tariff structure is relatively similar to those of the EAC and the proposed COMESA CU. There is therefore a limited incentive for trade deflection within the region. Trade deflection in a free trade area occurs if imports from outside of the area are routed via countries that impose the lowest external

[8] Under the 2006 Zambian Development Agency (ZDA) Act tariff exemptions are available to designated priority sectors. Examples include exemptions "(a) for five years on all machinery, fixtures and equipment, tools, motor vehicle parts, motor cycles and bicycle parts used in the assembly of motor vehicles, motor cycles, and bicycles; (b) for five years on inputs used in the textile and clothing industry, such as grey fabrics, machinery, sewing threads, sewing machine spares, and trimmings; (c) for five years of material used in the manufacture and packaging of cement, and manufacture of roofing sheets; (d) for five years on machinery and equipment acquired by enterprises that will operate in the proposed MFEZ/priority sector or rural enterprises; (e) for computer parts; and (f) on printed paper board used for packaging UHT milk." (Zambian Trade Policy Review, 2009, World Trade Organization).

tariff rate. Trade deflection also occurs when producers in third countries establish local 'screwdriver operations" to benefit from the trade preferences without the activity adding domestic value.[9]

To avoid this and to ensure that Zambia can collect its tariff revenue, it has to monitor rules of origin. Only products that originate in the free trade area are allowed to move freely across borders.[10] This imposes a cost on cross-border trade within the free trade area, which can be particularly high for landlocked economies such as Zambia. For example, exporters to Zambia are required to transit their goods through neighbouring countries – most imports are sourced via South Africa. These exporters are required to secure potentially payable duties and VAT by way of a surety bond or provisional payment. Import duties and VAT become payable should the goods not exit the transit country. Proof of export therefore needs to be provided for transit goods. These processes cost money and time.

The avoidance of costs associated with regulating and monitoring trade between partners of a free trade area is a key reason why countries form customs unions. By implementing a common external tariff, a customs union avoids trade deflection and rules of origin requirements for cross border trade amongst members are made redundant (see Box 1).

COMESA CU

The most pertinent trade policy challenge facing Zambia currently is the commitment on part of COMESA members to establish a customs union with a common external tariff. The CU was expected to commence from June 2012, but this is unlikely as members have not yet fulfilled the preparatory requirements with respect to its formation.

The key characteristic of a comprehensive Customs Union is that members apply zero tariffs on each other, but apply a common external tariff (CET) on all non-members. The same tariff schedule is therefore applied by all members on imports of products from outside of the region. The benefits of participating in a customs union are many, but also involve costs.

In evaluating its participation in a customs union, Zambian authorities need to consider what Zambia would want from a customs union in addition to what it currently gets under the Free Trade Agreement. For Zambia, the priority is the extent to which the customs union would reduce the costs of trading with and across the region.

A CU can achieve this in three ways. (a) the elimination of border controls on the internal flow of goods; (b) the elimination or simplification of rules of origin which were applied to prevent trade deflection; (c) the implementation of regional infrastructure and trade

[9] See Naumann (2011) for further discussion in relation to the Tripartite negotiations.
[10] A product originates in the country if it meets the specific rules of origin requirement. These include a specific processing requirement, a change in tariff classification and a value added or material transformation requirement. Exporters are required to obtain a certificate of origination from their revenue authorities if they wish to enter FTA partner countries duty free.

facilitation programmes to improve regional transport networks and harmonize processes governing the flow of goods (harmonize border and customs procedures, immigration procedures, transport procedures – insurance, standards, road user charges); and (d) regional industrial policies.

Additional benefits also apply. By negotiating as a group, the CU members can enhance their bargaining power in trade agreements with third parties. Customs unions also provide a framework for coordination and harmonisation of policies in a broader range of areas – as is reflected in the COMESA CU agreement which covers issues including trade facilitation, infrastructure, energy, movement of business persons, health and technical standards, etc.[11]

The primary advantage of the CU over the FTA, however, relates specifically to points (a) and (b). The other objectives can be achieved within the existing free trade agreements. Most of the economic gains from deeper regional integration therefore do not require the creation of a customs union.

Realizing the benefits of the single customs territory is critically dependent on the duty collection and revenue sharing scheme. Under a free trade area, revenue collection is in effect based on a destination principle. Each country levies import tariffs on imports from outside of the region, or on intra-regional trade that does not meet the domestic content requirements as set out in the rules of origin of the agreement.

In a fully implemented customs union, however, border controls on the movement of goods internally are removed. Customs revenue is collected at the port of entry and enters a common pool which is then allocated to members on the basis of some allocation rule. For example, in the Russia-Kazakhstan-Belarus customs union (initiated in 2010), the import duty revenues are allocated according a simple formula: Russia 88%, Belarus 4.7% and Kazakhstan 7.3%.[12] Internal border controls on the movement of goods amongst members have been eliminated.

The proposed COMESA CU embodies many of these characteristics, but with some important exceptions. A common external tariff has been agreed upon by members: 25% for final goods, 10% for intermediate goods and 0 percent for raw materials and capital goods. Individual countries are provided some flexibility with respect to protecting sensitive products during the transition period – up to 30 percent of product lines can be declared as sensitive products.

The major exception is that the revenue sharing arrangement that underpins a customs union has not yet been finalized. The proposed approach is based on the destination principle, as is currently being implemented in the EAC. In this approach each country is

[11] See COMESA site:
http://programmes.comesa.int/index.php?option=com_content&view=article&id=90&Itemid=142

[12] http://www.suomenpankki.fi/en/suomen_pankki/organisaatio/asiantuntijoita/Documents/focus_0610e.pdf

responsible for the collection of duties on imports from countries outside of the union.[13] Imports are required to remain in bond until they reach the country of ultimate consumption where the tariff is paid and kept. Certificates of origin are still required for across border trade between members to ensure that the goods comply with rule of origin requirements.

The formation of the COMESA CU has four important implications for the Zambian economy:

Firstly, Zambia cannot be a member of both a SADC CU and a COMESA CU. If both regional economic communities intend to form a CU, Zambia will be required to make a choice with respect to which CU it wishes to join. It is also not possible for individual members of a customs union to negotiate or participate in free trade agreements independent of other customs union members. Overlapping membership by CU members in different regional economic communities will require rules of origin restrictions and more importantly border controls to ensure that goods that enter under preferences in one country are not diverted into the remaining CU members who are not party to the preferential trading arrangement. These procedures undermine a key objective of forming a customs union, namely the removal of restrictions on internal trade flows.

Remedying these inconsistencies rests heavily on the success of the Tripartite FTA negotiations. If concluded, all members will have duty free access (subject to rules of origin requirements) into partner countries. In this case Zambia's participation in the COMESA CU will be compatible with continued preferential market access into the other SADC members. Zambia, however, will still be required to make a choice as to whether it joins either the proposed SADC CU or the COMESA CU.

The second implication is that Zambia loses its flexibility to set its own external tariffs. By participating in a customs union, Zambia cedes its sovereignty to set external tariffs to that of the union. The common external tariff will be periodically reviewed, but changes in the tariff rates will require consensus across all members, many of which have interests that do not necessarily coincide with those of Zambia.

The current CET structure may be suited to Zambia's current needs – the required changes to Zambia's tariff structure are relatively moderate – but over time these may change. The extensive use by Zambia of duty exemptions for development projects already reflects a need for flexibility with regard to the setting of tariffs, particularly on intermediate inputs.

[13] There are three types of Customs Union processes: (i) Centralized Customs model where all customs revenue is pooled and distributed according to an allocation rule (e.g. the Russia-Kazakhstan-Belarus customs union), (ii) Decentralized Customs model where revenue is collected at the destination (as proposed in the COMESA CU), and (iii) Clearing house model which embodies the destination principle, but collection of revenue is at first port of entry (as is being piloted by Tanzania, Rwanda and Burundi in the EAC - http://tmagazine.ey.com/wp-content/uploads/2011/04/New-duty-collection-and-revenue-sharing-scheme-in-the-East-African-Community.pdf).

A recognized problem with trade agreements is trade diversion. This occurs when imports from inefficient partners of the customs union displace imports from the relatively efficient (non-member) country because of preferential access. The effect is a loss of tariff revenue for the importing country and from a national standpoint, potentially a reduction in overall welfare that comes from buying more expensive products from members rather than less expensive products from non-members.

At the same time, Zambian firms may benefit from preferential access into the region, i.e. the diversion of partner country imports to Zambia. Finally, trade agreements have positive benefits through trade creation. The reduction of barriers to regional trade reduces domestic prices, enhances trade flows within the region and benefits consumers (See Box 2).

Box 2: Trade diversion and trade creation

Zambia currently imports fruit juices (HS2009) at a tariff rate of 25 percent. In a world of no preferences, Zambian consumers would purchase the fruit juice from the least-cost supplier globally (say France). The government would collect 25c for every dollar of fruit juice imported. Now assume that Zambia gives duty free preferential access to South African firms, where the cost of fruit juice is 24 percent higher than the least-cost producer globally. Under the free trade agreement, South African firms will have a competitive advantage over the least-cost global producer and Zambian fruit juice imports will be diverted to the high-cost South African firms. The effect is a reduction in Zambia's tariff revenue.[1] From a national standpoint, Zambia is made worse off because it has to pay 24 percent more for fruit juice.

Trade agreements also have positive benefits through trade creation. This occurs when providing preferential access reduces the price paid by Zambian consumers. In the example above, the price of fruit juice in Zambia should decline to the South African price, which is marginally lower than the tariff inclusive price of goods imported from the rest of the world.

Zambia's trade-off is between being able to benefit from rest of world imports into the region being diverted to its producers, its imports from the rest of world being diverted to relatively inefficient regional partners and the extent to which Zambian consumers gain in the form of lower prices in response to reduced barriers.

In the short run, the scope for further trade diversion or trade creation arising from Zambia's participation in the COMESA CU is probably limited as tariffs on members have already largely been eliminated and the tariff structures are relatively similar. However, this may change as the region industrializes. Close to a third of the CET lines have tariff rates of 25 percent, and another third have tariff rates of 10 percent. The scope for trade diversion in the future therefore remains considerable. In future, Zambia may therefore wish to mitigate the adverse effects of trade diversion*, but in a customs union, the key policy tool to do so, namely a reduction in external tariffs, is no longer under control of the Zambian authorities.*

It is possible to introduce flexibility into the CU. Provision for such flexibility during the transition phase of the COMESA CU have already been made – Member states are allowed to protect sensitive products during the transition period. However, flexibility for countries to set tariffs that differ from the CET in the long run can only be sustained if border controls on intra-regional trade are retained. This substantially diminishes the expected gains from establishing the CU.

This raises the third consideration. Zambia's interest in a customs union should primarily be based on the objective of using the CU to reduce the costs of trading goods within and across the region.

However, the destination principle whereby tariff revenue is to be collected as they enter the country of ultimate consumption will not eliminate customs procedures on across-border trade, including rules of origin requirements. Dutiable imports will need to be transported in bond as they transit through neighbouring countries. The rules of origin requirements are necessary to ensure that dutiable import destined for consumption in say Zambia, are not routed via Tanzania or Kenya. Given the destination principle of the COMESA CU, these controls are particularly important for Zambia, which as a landlocked country faces the possibility of extensive revenue loss from a CU if customs duties are paid at first point of entry and no further controls are established to monitor flow of goods between borders. For example, without rules of origin requirements and border controls on the flow of goods, importers would declare Tanzania as destination of ultimate consumption to avoid the costs associated with transporting goods through Kenya and Tanzania in bond.

The implication is that imported goods will continue to be subject to customs procedures at each border post and face additional transport costs associated with bond and other administrative requirements.[14] In this context, *the COMESA CU functions no differently to a free trade agreement where members apply the same external tariff*. The key difference, however, is that whereas in a FTA countries retain policy flexibility, in the CU the country loses autonomy over the setting of tariffs.

The final implication of Zambia's participation in the Customs Union is that customs revenues are likely to fall. Although Zambia's tariff structure is simplified and there is a reasonable overlap of its tariff rates (39 percent of tariff rates) with those of the COMESA CET, the adoption of the COMESA CET will nevertheless reduce average levels of protection and therefore customs revenue. [15] Simulations of the COMESA CU

[14] Importers and exporters are required to lodge a bond against duties payable if the good enters the transit country's domestic market. In most cases, bonds are required to be registered with financial institutions located within the transit country.

[15] 59 percent of Zambian tariff rates do not directly correspond. For a comprehensive assessment of the revenue implications for Zambia of implementing the CET, see Cheelo, C., M. Malata and J. Tembo (2012) What Do the Forthcoming COMESA Customs Union and COMESA-EAC-SADC Tripartite Free Trade Area Mean for Zambia? ZIPAR report.

indicate that tariff revenues may decline by 21 to 23 percent.[16] The decline in total revenue is smaller and ranges from 1.8 percent to 2.1 percent.[17] Nevertheless, alternative revenue sources will need to be found.

Our recommendation is that Zambia proceed with caution when entering into the COMESA CU. Zambia should consider the option of a *de facto* adoption of the COMESA CET, while retaining the option of altering its external tariffs if circumstances change and until it, and other members believe that a fully-fledged customs union (without internal border posts) can be adopted.

Tripartite Free Trade Area

Another challenge facing Zambian authorities is the Tripartite Free Trade Area negotiations. If successfully concluded, the Tripartite Free Trade Area will liberalise trade among 26 Member States of three Regional Economic Communities: COMESA, EAC and SADC. These countries make up half of the African Union in terms of membership and currently contribute 58% of its total GDP, estimated at approximately USD 1 Trillion.[18] Economic integration in the Tripartite region is to be anchored on three pillars:

(i) market integration (removal of tariff and non-tariff barriers and implementation of trade facilitation),
(ii) infrastructure development (to improve efficiency of internal trade and transport network), and
(iii)industrial development.

Zambia, through its dual membership, currently benefits from duty free access into both COMESA and SADC. Under the Tripartite FTA, all members will have duty free access into all markets. For countries in SADC that are not members of COMESA and for countries in COMESA that are not part of SADC, this agreement brings potential for greater integration. Egypt, for example, does not have duty free access into South Africa, and visa-versa. The political ramifications of integrating Africa from Cape to Cairo also have strong resonance.

However, for dual members such as Zambia the impacts are uncertain. A Tripartite FTA will erode Zambia's preference margins in SADC and COMESA. It also raises the

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[16] The analysis by Cheelo et al. (2012) indicates that more than half of the decline in tariff revenue from the formation of the customs union can be attributed to the CET being applied to the Gulf States. This reflects the relatively high tariffs Zambia imposes on petroleum imports – the simple average MFN tariff on HS 2709 to HS 2713 is 17 percent. Bar a few exceptions, the COMESA CU tariff on these products is zero. Zambian authorities can therefore mitigate the revenue impact of the COMESA CU by using alternative taxes on petroleum products.

[17] See Cheelo et al. (2012) and Paul Brenton, Mombert Hoppe and Erik von Uexkull (2007) "Evaluating the Revenue Effects of Trade Policy Options for COMESA Countries: the Impacts of a Customs Union and an EPA with the European Union." Paper prepared as part of the World Bank - COMESA Joint Work Program for regional integration and EPA negotiations. (http://siteresources.worldbank.org/INTRANETTRADE/Resources/239054-1196261607599/4442906-1253912908321/COMESA.pdf)

[18] TradeMark Southern Africa, http://www.trademarksa.org/node/8084

possibility of trade diversion. For example, Zambia is currently an attractive location compared to Kenya for a firm wishing to sell goods locally as well as to Egypt (under the COMESA FTA) and SA (under SADC). Kenya is only part of the COMESA FTA and hence does not have duty free access into South Africa. With the Tripartite FTA, Zambia loses its competitive position vis-à-vis Kenya in terms of its preferential access into South Africa. A possible outcome is that the Zambian firm decides to use Kenya as its regional production hub and therefore relocates its production facilities. In addition to the loss of production facilities, imports of these goods are diverted to Kenya.

This does not imply that the Tripartite FTA will be of no benefit to Zambia. Rather Zambia's interests in these negotiations are specific. The gains for Zambia in the negotiations will not accrue through improved market access in the form of lower tariffs. Rather, the gains will accrue through policies that deepen integration, reduce trade costs, and remove non-tariff barriers that restrict trade flows.

In the Tripartite negotiations, Zambia's interests are to reinforce and prioritize the pillars dealing with regional infrastructure as well as the trade facilitation and non-trade barrier dimension of the market access pillar. In addition to these, the negotiations may provide Zambia (and other SADC members) with an opportunity to re-negotiate the complex product specific rules of origin that currently apply to the SADC FTA. The SADC FTA rules of origin frustrate intra-regional trade and reflect protectionist interests rather than providing a framework to avoid trade deflection.[19]

The Tripartite FTA also has an important bearing on Zambia's participation in the COMESA CU. The Tripartite negotiations provide the region with an opportunity to resolve inconsistencies associated with the overlapping membership of the regional economic communities. It is not obvious, however, that it is advantageous for Zambia to enter into these negotiations as a member of the COMESA CU. As noted, Tripartite FTA exposes Zambia to the potential of further trade diversion, but if it enters the COMESA CU it loses its ability to mitigate the diversion effects.

Our recommendations are therefore that Zambia focuses its negotiations in the Tripartite FTA around the non-tariff dimensions of the agreement. New bold agreements for trade facilitation that substantially reduce trade costs will be of particular importance for the Zambian economy. Simpler and less restrictive rules of origin are also needed to increase opportunities for Zambian firms to export to into SADC. A reduction in trade costs and simpler rules of origin will greatly facilitate the emergence of the regional production networks that characterise the rapid export growth of manufactures in East Asia.

[19] Hartzenburg, T. 2011. *Cape to Cairo – Making the Tripartite Free Trade Area work*, Tralac, Stellenbosch. See also Flatters, F. and R. Kirk (2004) "Rules of Origin as Tools of Development? Some Lessons from SADC." in Cadot, O. et al. eds. *The Origin of Goods: A Conceptual and Empirical Assessment of Rules of Origin in PTAs*. Washington: IADB- and CEPR.

Monetary Union[20]

The stated intention of Comesa members is to form a monetary union (MU) by 2018. The objective is "to create a common area of monetary and financial system stability which will facilitate integration of the financial markets in the region in particular and economic integration and economic growth in general."[21]

The programme of establishing the monetary union first focuses on the implementation of policy measures to achieve macroeconomic convergence. This is followed by the introduction of a formal exchange rate union and finally the establishment of a full monetary union involving the use of one common currency issued by a common Central Bank. This programme closely follows the evolution of the European Monetary Union.

The current crisis in the European economic and monetary union provides sufficient warning to all countries considering the formation of a monetary union. The benefits of the union need to be weighted up against the costs.

There are a number of advantages of a monetary union. A single currency reduces transaction costs, eliminates direct exchange rate risk of cross-border investment and trade, and facilitates price comparability. The strongest gains, however, may be that the monetary union can be used as instrument for domestic reform, including reducing inflation and national debt. These gains accrue to economies during the transition phase, but membership in the monetary union also disciplines policy makers to maintain control over inflation (disciplines increases in wages and non-traded services and restrains depreciation of the currency for short term economic gain) implying persistent gains.

Participation in a MU, however, requires considerable loss of monetary policy autonomy. Countries that join a monetary union give up their flexibility to set monetary policy tailored to their own particular circumstances or shocks. Exchange rates, which act as a key adjustment mechanism for country-specific shocks are now determined at a regional level. The domestic exchange rate therefore no longer adjusts to local shocks in competitiveness, terms of trade, technological change, etc.

In addition to monetary integration, a monetary union requires fiscal integration or at least binding rules on fiscal policy. The need for such fiscal integration is most evident in the emergence of the European financial crisis. Such fiscal integration could also require common fiscal stabilisation policies. This includes a risk sharing system such as an automatic fiscal transfer mechanism to redistribute money to areas/sectors which have experienced economic setbacks. In addition, strict fiscal controls are required to ensure that countries do not run high deficits, as the market feedback mechanisms (increased

[20] The programme of establishing a monetary union has the following stages: (1) consolidation of existing instruments of Monetary Co-operation and implementation of policy measures aimed at achieving macroeconomic convergence; (2) introduction of limited currency convertibility and informal exchange rate union; (3) formal exchange rate union and co-ordination of economic policies by a common monetary institution; and (4) full Monetary Union by 2018 involving the use of one common currency issued by a common Central Bank (http://programmes.comesa.int).

[21] http://programmes.comesa.int/index.php?option=com_content&view=article&id=85&Itemid=139

interest rates, weaker exchange rate), do not function in the same way as if the economy had monetary independence.

Zambia's participation in a monetary union would therefore entail substantial loss of policy autonomy with regards to the setting of monetary policy as well as fiscal policy. In forming a monetary union, COMESA members need to give up monetary and fiscal autonomy and have a high degree of trust in other members. Participation in a monetary union is therefore not to be taken lightly and the great diversity of membership suggests that jointly developing such policies would imply a considerable loss of economic sovereignty.

In evaluating its position, Zambia, needs to weigh the gains with the losses. Not all countries or regions are suited to the formation of a monetary union. The benefits of a monetary union are much greater the more closely integrated is the area with respect to international trade and factor (labour and capital) movements (See Box 3).[22] In addition, the benefits are greater if all economies experience common macroeconomic shocks. Asymmetric macroeconomic shocks may require country-specific monetary policy responses – an option not available to countries within a monetary union.

Box 3: Optimal Currency Areas

The theory of optimal currency areas suggests the following requirements for maximising the benefit of a monetary union:

(1) Common business cycles. Countries with common business cycles are less likely to experience asymmetric or idiosyncratic macroeconomic shocks that require country-specific monetary policy. A key element in minimizing asymmetric shocks is similarity in economic structure, particularly industrial structures across countries.
(2) Labour mobility (Mundell) – free movement of labour, cultural similarities: Labour mobility helps to smooth adjustment to region/country specific shocks.
(3) Deep integration with capital mobility and price and wage flexibility across the region (McKinnon).
(4) Finally, the countries are already deeply integrated with respect to international trade flows.

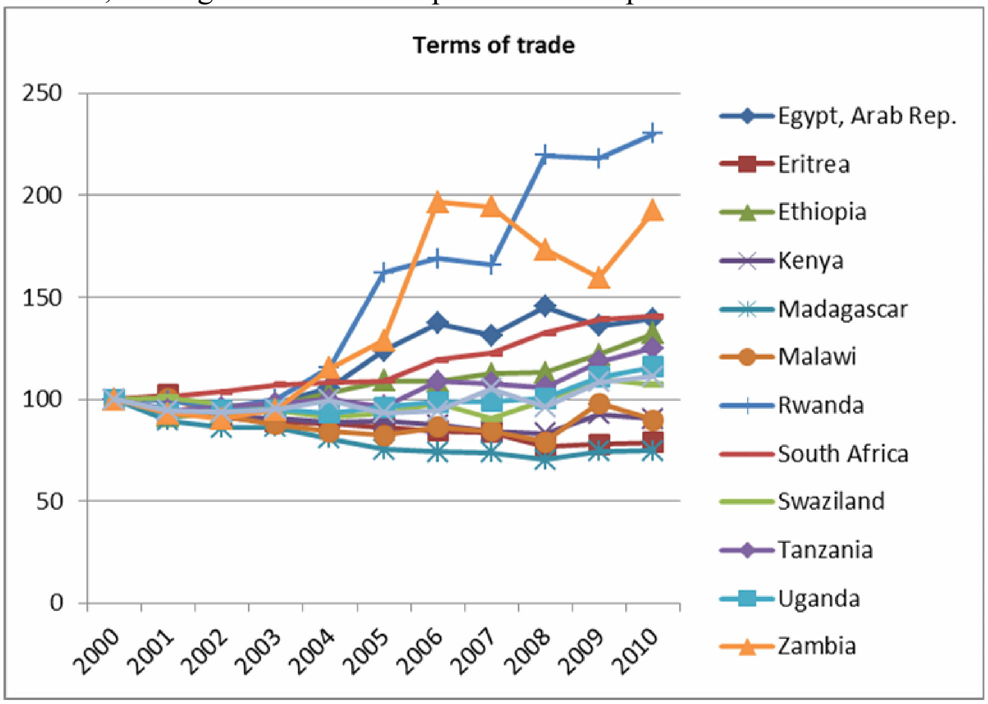
These requirements suggest that the COMESA members are still some way off from meeting the conditions required for an optimal currency area. A major factor impeding the emergence of a monetary union is that the economic structures of the COMESA economies differ enormously. Most of the economies are highly dependent on a few resources – copper in the case of Zambia. This exposes members to very specific external trade shocks (See Box 3). Zambia's macroeconomic environment, for example, is particularly vulnerable to changes in the international price of copper. Collapses in the copper price could be offset in part by depreciation as long as the currency is flexible.

[22] Feldstein, M. 2008. Optimal Currency Areas, http://www.nber.org/feldstein/optimacurrencyareas.html

However, in a monetary union, it would require fiscal transfers to stabilise economy. The same holds for other COMESA members.

Box 3: Terms of trade for COMESA Members

The terms of trade – the price of exports over the price of imports – is one indicator to assess the extent to which economies within COMESA experience common external shocks. As indicated in the figure, COMESA members are characterised by a high degree of asymmetry in respect to shocks in the prices of their traded goods. Zambia's terms of trade are strongly influenced by the copper price. Over the past decade, Zambia's price of exports rose by close to a 100 percent compared to its average price of imports. In contrast, its neighbour Malawi experienced a 10 percent decline in its terms of trade.



Source: World Bank Development Indicators

In sum, one the strengths of COMESA or a tripartite FTA is the diversity of its membership. This suggests some potential for gains from trade. But this same diversity also implies that monetary integration should be approached with great caution. In our view, the COMESA region is far from an optimum currency area and the European experience has underscored the dangers of operating such a system with the requisite institutional frameworks and disciplines. Accordingly, we would recommend that the monetary authorities concentrate their regional efforts on regulatory cooperation and the more complete integration of financial markets. The number of foreign banks and other financial institutions that operate in Zambia are indicative of the potential gains that could come from bottom-up integration of the market for financial integration. However, full monetary integration should be avoided for the foreseeable future.

Conclusion

This paper analyses the challenges currently presented to Zambian regional policy. Four conclusions can be drawn from the analysis.

While Zambia should adopt the same tariff as other COMESA members, it should be cautious about losing its tariff-setting ability and accepting the legally binding obligations of customs union membership until the members of COMESA are able to remove their internal customs barriers.

Zambia should participate in the SADC as an FTA member but cannot belong to two customs unions unless they adopt the same external tariff.

Zambia's privileged position as a member of both SADC and COMESA will be eroded by a new Tripartite FTA. Its participation in that initiative therefore would only be beneficial if the agreement provides for improved trade facilitation, less restrictive rules of origin and other measures to reduce trade costs.

Finally, while initiatives to facilitate regional financial cooperation should be supported, monetary union at the regional level is not desirable for the foreseeable future.

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