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Trade instruments, National policies and Continental transformation: Constraints and emerging issues for African Union Continental Free Trade area policy.

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Abstract

This paper describes how erecting barriers to continental integration, limiting full implementation of trade instruments such as the Africa Union Continental Free Trade Area, links trade agreements to non-trade issues such as full continental integration policies and under certain strict conditions, helps fully participating countries and governments to lower tariffs and/or adapt continental integration protocols (policies). Using mathematical derivation, logic, and series of arguments conditions were advanced. These are: (i) individual government's goal is to maximize their objective functions (ii) these objective functions are sufficiently concave with respect to barriers to full adaption of continental integration (iii) the 'no abandonment' conditions define a space for full adaptation function (iv) inter countries, interregional, intraregional bloc's policy outcomes are complementary in strategic terms. These findings can be used as sufficient rational for enhancing a wider acceptability in the continental free trade area policy. The paper simply recommends that imposing higher tariffs or drastically reducing tariffs of AUCFTA participating nations is optimal if the complementary relationship between the different policy position is sufficiently large, and that the non-pecuniary cross-border externalities is sufficiently valued.

INTRODUCTION

Trade has direct impact on the quality of life of people (Lamy, 2012). In a regime of free and fair trade, enshrined is the policy of non-discrimination, inclusive growth and pro-poor safe guard mechanisms. Bagwell and Staiger (1999) provide a framework for efficient bargaining which is the bedrock of modern international regimes.

Based on mutually acceptable outcomes which are granted by full cooperation of participating countries linkages between trade and non-trade issues are the best of route for ensuring quality of life is improved over time. Each negotiating country has its trade objective spelt out at the onset of a trade talk. Subsequently, negotiation is ensued, concessions are granted/exchanged and a broad, all-inclusive agreement is reached. However, referring to the Doha Trade Round where some countries introduced linkages between trade and non-trade issues as a panacea for ensuring continuous improvement in life, they proposed linking trade outcomes with environmental standard. The Paris accord has further strengthened this linkage based on the outcomes of the Kyoto environmental protocol. This scenario has brought to light the increasing need to further use the insights to advance the African Union Continental Free Trade area policy which was hitherto rejected by a number of African countries.

It is noteworthy to posit that there is no existing international legal obligations enforcing non-trade issues linked to trade except participating countries are actively engaged diplomatically to fully understand, key in and adapt. I must submit however, that it takes quality time and resources. Non-trade issues are responsible for the barriers and/ or inertia to continental free trade/economic integration due to myopic interest, (e.g. Nigeria did not sign the AUCFTA and some other countries abstained, even though over forty countries sign in Kigali). This is quite instructive of the need to engage.

This conclusion is important because it provides a rationale for engaging governments robustly on the Africa Union Continental Free Trade Area (henceforth denoted AUCFTA) as will be elaborated on in the discussion.

To handle this task, a general equilibrium set up is used, in which two competing regional blocs – A and B – with two countries 1 & 2 in bloc A and countries 3 & 4 in bloc B. Within one bloc, country 1 imports what country 2 exports. Also, bloc A imports what bloc B exports and vice versa. In this simple framework outlined, if one government of a country unilaterally initiates and implements a plan of action such as tariff revision, barriers to free trade, and/or refusal to integrate economically, they automatically impose higher cost and system dysfunction as equilibrium will be distorted. Therefore governments have a motivation to set out trade objectives/outcomes, negotiate, and exchange concessions and reach a mutual agreement. Cooperation among government entails agreements are self-enforcing. A non-trade consideration with non-pecuniary cross-border externalities such as national barriers to continental integration are associated with higher externalities. For simplicity, let's assumed that there is no formal linkage in international negotiations between trade and the inertia to continental integration. International or continental trade issues are negotiated without bias regarding such barriers such as refusal to sign a policy. Secondly, there is no formal commitment in the negotiation to tie concessions on trade issues to discussions to integrate any further. Government may choose not to negotiate at all on the non-trade issue or simply refuse to give accent since their objectives differ. For example countries whose presidents refused to sign the AUCFTA deal, or completely stayed away from the signing ceremony had the trade representative(s) who followed the process of negotiation through to its logical conclusion.

To fully understand its welfare ramifications and importance in implicitly linking international agreements and legal obligations, lets pose a cooperation between country 1 (Region A) and country 3 (Region B). Since AUCFTA is a rule base institution, tariff imposition on non-participants increases the cost for deviation. The paper therefore compliments Baldwin (2013) by showing that in AUCFTA self-enforcing agreements, restricting tariff to AUCFTA non-participants not only increases the ability to punish deviation thereby reducing the incentive to deviate. AUCFTA alters the outcomes of the separate standard setting, via the impact that AUCFTA has on tariff outcome, in a way that enhances welfare. We observe an implicit linking even when there is no explicit linking.

Applying a multi segmented market, Drake-Brockman and Stephenson (2012) show that substitutability creates enforcement space (see also Hummels, Ishii, & Yi, 2001). This result was applied in Stephenson (2012) who investigated the benefit of linking trade and inertia to continental integration, for instance, government that maximizes social welfare function face a unique multi-country cooperation dilemma. Other paper include Woodrow (2001) who used a cooperative approach to study the effect of linkage on blocking coalition. Sheehan (2008) assumed that governments choose trade and non-trade policies at a super game level, where a two-country, two policy matrix is at stake. This paper assumes the four countries and also governments do not link explicitly policy instruments. For instance, AUCFTA is a multilateral agreement, whereas each country's national policy are part of a per country's unique positioning on non-trade issues (where some countries disengage, enforcing their fundamental sovereignty rights).

Sheehan (2008) demonstrates the strategic incentives for countries to abstain from continental wide policies that share similarities with the AUCFTA protocol. He argued using Lee, Gereffi, and Barrientos (2011) definitions that there are conditions for linkage for it to be attractive and beneficial to government that are skeptical. This paper assumes that non-pecuniary cross-border externalities are sufficiently valued.

Section 1 introduces the subject matter while section 2 outlines the economic structure and section 3 describes the multilateral agreement. Section 4 introduces an AUCFTA agreement on non-trade issues and sheds new lights on liberalizing trade. Section 5 dwells on optimal requirements, while section 6 concludes the paper.

A four country economic aspiration model structure

The model includes four competing countries in two regional blocs – A & B on a continent Z. It is assumed that countries 1 & 2 have comparative advantage in producing x while countries 3 and 4 have producing y. Given that consumers use both products – x and y - in equilibrium, country 1 and 2 export x to country 3 and 4 and import y in return.

Let τ be the continental body's trade instruments and its resultant tariff levied on imports by countries within their blocs.

Define $p^i = p_x^i / p_y^i$ 1

Where

$i = 1, 2, 3,$ and 4 respectively.

$P_x^i =$ prices of x in their countries

$P_y^i =$ prices of y in their countries

For the sake of simplicity, tariffs are non-prohibitive. Secondly, 'world prices' and the 'domestic' prices are defined

$P = pw^A + \tau pw^A$ 2

Where

$pw^A = p_x^i / p_y^i$

Now let s denotes each regional body's countries' policy or barriers to integration. This denotes, for example, African Union Continental Free Trade Area, AUCFTA, targets, where higher number of countries domesticating (exactly 40 countries signed out of 54, representing 74%, success rate) are associated with a lower number. Also let \hat{s} be $s^1_c, s^2_c, s^3_c,$ and s^4_c

It is customary to add that cross border externalities exist. For example, an increase in barrier to continental integration policy in country 1 exerts price pressures and increases cost, etc. in country 2, and bloc B.

This model won't work without inserting that production in countries 1, 2, 3, and 4 is efficiently determined by selecting a point on the production possibility frontier such that the marginal rate of transformation between x and y equals the local relative prices. The impact of rejecting, for instance AUCFTA instruments, can alter the shape of a country's production possibility frontier and in turn, affect its production choices over time.

The quantity of y supplied in any country based on the prevalent s (integration policies adapted) is 3

Where,

$$\delta s_{yi} / \delta (1/p) > 0$$

$$\delta s_{yi} / \delta Q_s > 0$$

Also the quantity of x supplied in any country based on the prevalent s (integration policies adapted) is

$$S_{xi}(1/p) \tag{4}$$

Where,

$$\delta s_{xi} / \delta (1/p) > 0$$

$$\delta s_{xi} / \delta Q_s > 0$$

$i = 1, 2, 3,$ and $4.$

Consumers are identical across countries and regional bloc and hence consumption is a function of local relative prices and tariff revenues. Therefore, domestic price of x and y is defined as:

$$C_x(P,r) \tag{5}$$

$$C_y(P,r) \tag{6}$$

Where,

$$\delta C_x / \delta p < 0 \text{ and}$$

$$\delta C_x / \delta (1/p) < 0$$

Consequently, consumption can be expressed as a function of barriers to full integration. For example is a policy barrier that frustrates economic integration that aims to lower cost, etc. This can take the form of subtle restrictions made in a particular way.

Next, similar to work of (Ghemawat, and Altman, 2012), we can use the budget constraints of the countries coupled with their market clearing conditions to derive a reduced/optimized form of the government objective functions. Hence remember that the objective functions stated earlier

$$W^A = f(W^1_c, W^2_c, W^3_c, W^4_c) \tag{7}$$

Where if $\alpha = (W^1_c = 0; W^2_c = 0; W^3_c = 0; W^4_c = 0)$

Then

$$\delta W^A / \delta W^i_c > 0$$

where

$i = 1, 2, 3,$ and $4.$

Assume that

$$W^A = W^1_c (\gamma^1_c \hat{s}^1) W^2_c (\gamma^2_c \hat{s}^2) W^3_c (\gamma^3_c \hat{s}^3) W^4 (\gamma^4_c \hat{s}^4)$$

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Where

$$\gamma^A = (\gamma^1_c, \gamma^2_c, \gamma^3_c, \gamma^4_c) \text{ and}$$

$$\hat{s} = (\hat{s}^1 \hat{s}^2 \hat{s}^3 \hat{s}^4)$$

Assumptions

$$\delta^2 W^A / \delta \gamma^i < 0 \text{ and}$$

$$\delta^2 W^A / \delta \hat{s}^i < 0$$

$\delta^2 W^A / \delta \gamma^i < 0$ implies that a decrease in tariff revenue, γ^i across the countries in the competing blocs A & B reduce cost, thereby triggering increase in trade and cross-border migration and therefore increases $\delta W^A / \delta \gamma^i$

The motivation $\delta^2 W^A / \delta \hat{s}^i < 0$ is that an increase or upsurge in mounting barriers to integration, lowers $1/p$ and therefore decreases the amount of x consumed in A and B. This implies that all else being equal, $\delta^2 W^A / \delta \hat{s}^i$ decreases, since the volume of trade in x decreases.

The government policy barrier game

This section describes a hypothetical one period game, which is extended to an infinitely repeated framework.

One period policy

Since there are barriers inhibiting the full domestication of continental economic integration policies and there are no dynamics, the economic integration equilibrium on x and y are derived from the game played by two regions A and B when they choose $\gamma^1_c, \gamma^2_c, \gamma^3_c$, and γ^4_c respectively, so as to maximize their own objective functions. Adapting the Nash equilibrium to this arguments, each African region - A and B, trade instruments satisfies its first order conditions (FOC). In other words, the two countries' FOC are:

$$\delta \text{Country 1} / \delta \gamma^1 = 0$$

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$$\delta \text{Country 2} / \delta \gamma^2 = 0$$

10

$$\delta \text{Country 3} / \delta \gamma^3 = 0$$

11

$$\delta \text{Country 4} / \delta \gamma^4 = 0$$

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and the Nash tariffs are $\gamma^1_c, \gamma^2_c, \gamma^3_c$, and γ^4_c respectively.

Therefore,

$$\gamma_c = (\gamma^1_c, \gamma^2_c, \gamma^3_c, \gamma^4_c)$$

Each governments' desire to fully adopt zero tariff or free trade is derieved. In other words, regional bloc's R 's FOC is

$$\delta \text{Country}(i = 1 - 4) / \delta s = 0$$

Whereas the FOC of countries 3 and 4 are respectively

$$\delta \text{Country}3 / \delta s = 0$$

$$\delta \text{Country}4 / \delta s = 0$$

The Nash coefficient for economic integration policies by R_s (Countries 1, 2, 3 &4) are denoted by $s^1_c s^2_c s^3_c$ and s^4_c respectively.

In addition,

$$\hat{s}_c = (s^1_c s^2_c s^3_c \& s^4_c)$$

In sum, regional bloc's actions in the one-period subgame perfect equilibrium are for R_1 .

$$\gamma^1_c, \gamma^2_c \& \hat{s}_c$$

and for R_2 their actions are

$$\gamma^3_c, \gamma^4_c \& \hat{s}_c$$

For the sake of simplicity, we assume that there is a unique interior Nash equilibrium within each regional bloc in the static game. In this argument, the Nash equilibrium is inefficient. The reason is that government within these regional blocs do not internalize the full terms of trade, full economic integration policies when setting their own domestic policies and therefore the rate of growth is too low. Moreover, economic integration policies in equilibrium are inefficient since cross- border effects in African interregional blocs exist ILEAP (2012).

Next, we extend this framework to two or more period model to assess cooperation in internalizing fully terms of trade and economic integration policies. Here, the benchmark care for cooperation is limited to trade instruments and economic integration instruments (Though this assumption is released in section 4). It is assumed that when a country choose to delay or not implement an economic integration policy or trade instrument, it deviates from the equilibrium path and as such all countries revert to their domestic interior (within bloc) Nash equilibrium in the static game, beginning from the next period onward.

Multi-period policy

The continental body’s facilitation negotiation stage.

The consultation between the four governments within this framework are modeled as a continuous game. This game is an infinite repetition of the static scenario outlined in the section above, whereby as of time O, the governments based on recommendation and protocols of the AU agree on the full economic integration and trade instruments such as tariffs for sector X and Y inter-country and inter regional bloc negotiation conclude and converge on a point on the efficiency frontier. That means they choose inter regional bloc and trade instrument that maximize their welfare functions

$$W^A = f(W^1_c, W^2_c, W^3_c, W^4_c)$$

Where,

$$\delta W^A / \delta W^1_c > 0$$

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$$\delta W^A / \delta W^2_c > 0$$

14

$$\delta W^A / \delta W^3_c > 0$$

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$$\delta W^A / \delta W^4_c > 0$$

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for two competing regional blocs and four countries.

Furthermore, within a regional bloc, if

$$W^1_c = W^2_c,$$

Then

$$\delta W^A / \delta W^1_c = \delta W^A / \delta W^2_c$$

Henceforth,

$\alpha_A = \alpha^1_c; \alpha^2_c; \alpha^3_c; \alpha^4_c$ will be termed as the most widely adopted and adapted trade instruments.

Post negotiation stage

This paper bases on its derivations on the assumptions that no country within the two competing bloc is forced to make commitments on issues and government policies and therefore the extent of adoption and adaptation of interregional trade instruments, policies and continental body’s trade instruments will be independently set by each other. However, to operationalize the model, governments hand pick the trade instruments that best compliments their objective functions, therefore safe to conclude that they operate at multilevel that optimize their Nash levels.

The instruments that countries will adopt and adapt the most are those that are best described by Lamy (2013), ITC (2013) and (Ghemawat, and Altman (2012). Let's derive the conditions where no country abandons the continental body's instruments and then discover their characteristics. Obviously, a country that abandons instruments cannot outperform others abiding fully and clearly cannot do better than if it complies. Hence, if country 1 abandons its imports, its capacity to fully integrate will equal its level in a static analysis or game.

$$\tau_A = \tau_{c(A)}^{1_{cc}} \quad (17)$$

Where the subscript cc denotes the variables when the countries cooperate to actualize continental mandates and c(A) denotes a countries abandonment of instruments due to myopic considerations.

Therefore, by fixing τ_{cc}^1 we can characterize country1's incentive to abandon as being equal to the difference between the welfare benefit derived from playing a myopic strategy and that gained through cooperation to fully actualize all mandates.

$$\Omega \tau_{cc}^1 = W^A \tau_{c(A)}^1 - W^A \tau_{cc}^1 \quad (18)$$

by fixing equation 18 we characterize country1's gain by abandoning the protocols as being equation 18.

We therefore expect the future gain to country 1 from not abandoning today as

$$W^A \tau_{cc}^1 = \delta / (1 - \delta) [W_{c(A)}^1 \tau_{cc}^1 - W_{c(A)}^1 \tau] \quad (19)$$

We can now derive a fully internalized trade instruments using equation 17, 18 and 19. If the continental body mandates are fully adapted, trade instruments such as tariff rates will be such that no country has an incentive to abandon.

The 'no abandonment' conditions derived here defines the space for full adaptation function. There are certain conditions that must be met to satisfy equation above. The focus of this paper is to keep $W_{c(A)}^1$ (where I = 1, 2, 3, and 4) fixed where

$$W_{c(A)}^1 = W_{c(A)}^1 + W_{c(A)}^2 + W_{c(A)}^3 + W_{c(A)}^4$$

We can then establish full adaptation function. The four country negotiation will be guided largely by this constraint maximization problem.

$$\text{Max } (\tau_{c(A)}^i) [W^A] \quad (20)$$

Subject to: $\Omega \tau_{cc}^i \leq W_{c(A)}^i \tau_{cc}^i$

Where i = countries 1, 2, 3, and 4

If δ is too large within the dictates of this system the threat of abandoning protocols is real and eminent.

Linkage and AUCFTA

Continental free trade regimes have been a burning topic in international trade agreement for over 100 years. Also this policy strategy gave rise to North American Free Trade Area, European Union's version etc. It is also widely accepted as the pillar of the World Trade Organization system. The bedrock of this system is that each participating member give equal treatment to good and services of all other members in the application of trade policies. In practice, AUCFTA policy implies that every time a country lowers a trade barrier or fully adapts continental

integration without alteration, it must do so for the same goods or services from all other members' continental trading partners.

The AUCFTA rules carry with it potential cost associated with free trading areas on the bargaining outcomes of others. The cost of free trading areas has been emphasized since the work of Viner (1924) and formalized in Caplin and Krishna (1988). Ludema (2001) however posed the discretion of member countries to sign on or reject any agreement negotiated on their behalf. This ratification process allows the countries to exercise their sovereignty right. The core benefit that AUCFTA has is the ability to reign in opportunistic behavior by competing government that might undermine continental trade.

The benefit derivable from AUCFTA is not limited, however to curbing since it also offers incentives to cooperate and integrate. To this end, the paper shows that in an AUCFTA self-enforcing agreement, restricting tariffs to non-participators' basis, not only decreases the ability for deviation but also increases benefits from cooperation and integration.

The paper argues that restricting tariffs to non- AUCFTA participants implicitly links trade and non-trade agreements, where conditions for participating in AUCFTA are derived that is for

$$\tau^1_c = \tau^2_c = \tau^3_c = \tau^4_c \tag{21}$$

are derived. The conditions are derived where countries opt for AUCFTA simply because doing so raises their welfare function optimization.

Let's start by assuming Country1, Country 2 and Country 3 cooperate on their national policy on integration. The equilibrium level is set between them. Whereas Country 4 set its own preference. Let M denotes cooperating countries.

Where,

$$\hat{S}_m = (S_m, S^1_m, S^2_m, S^3_m) \tag{22}$$

We can show that

$$W^A(\tau \hat{S}_m) \geq W^A(\tau \hat{S}) \tag{23}$$

The basis for this argument is that it is assumed that negative cross-border effects exists while government ignores it. Therefore the preferential treatment between C₁, C₂, and C₃ implies.

Argument:

Assume that C₁, C₂, and C₃ set S while S₁ S₂ and S₃ cooperative and assumption holds. If a multilateral trade agreement is signed then

$$\tau^1_c \leq \tau^4_c$$

$$\tau^2_c \leq \tau^4_c$$

$$\tau^3_c \leq \tau^4_c$$

If tariffs are not imposed on non-AUCFTA participators, the willingness of C₁, C₂, and C₃ but not C₄ to cooperate on non-trade issues imply that they three countries lower tariff and integrate fully (more). The reason follow directly from the assumption that continental integration and tariff are compliments. The results can now be derived easily from the no-defection condition.

Hypothesis:

Given assumption restricting tariffs to non-AUCFTA participants maximizes W^A (Africa's welfare) if the following are met:

1. $\delta W^A / \delta S^4$ is sufficiently large. That is cross-border externality is large enough.
2. $(\delta W^4 / \delta S^4 - \delta W^{1-3} / \delta S^{1-3})$ is sufficiently large. That is government's objective functions are sufficiently concave with respect to continental integration.

3. $\delta^2 W^4 / \delta \gamma^4 \delta S^4$ and $\delta^2 W^4 / \delta S^4$ are sufficiently larger than $\delta^2 W^{1-3} / \delta \gamma^{1-3} \delta S^{1-3}$. That is increasing γ^{1-3} and decreasing γ^4 by a small amount can yield a large enough change in S^4
4. Moreover, $\gamma^{1-3}_c \leq \gamma_{AUCFTA} \leq \gamma^4_c$; where AUCFTA denotes tariff constraints in favour of AUCFTA. In addition, it means full integration in C_1 to C_3 and almost exclusion to C_4 compared with a no AUCFTA regime.
5. Therefore in the hypothesis, the condition under which government gain from AUCFTA tariff regime are derived. These are the condition whereby the marginal outweighs the cost. The cost and benefit stems from the no-defection constraints. If the negative cross-border externality is large enough and the marginal benefit is declining restricting tariffs to non- AUCFTA maximizes Africa's welfare. The reason is that AUCFTA agreements on non-trade issues introduce asymmetry between C_1, C_2, C_3 and C_4

Optimal Measures

Pivotal to WTO is lowering non-trade, non-tariff barriers. It is instructive to note, however that AUCFTA compliments WTO as it further enhances the welfare of Africans. We note for that WTO achieved its objectives by maintaining no external enforcement mechanism to punish violators.

It is imperative to highlight that participating nations made it a top priority to pursue WTO mandates with sufficient negotiation and robust engagement. Therefore, African governments and AUCFTA cannot be an exception.

This brings us to an interesting extension. Introducing telecommunication shocks to the model can shed some interesting dimension to the entire AUCFTA model. Furthermore, the paper can be viewed as a basis for AUCFTA model being used to decrease production cost across the continent.

CONCLUSION

In summary, the paper sheds new light on the optimal use of tariffs and continental economic integration in a self-enforcing agreement. It supports the view that imposing higher tariffs or drastically reducing tariffs of AUCFTA participating nation is optimal if the complementary relationship between the different policy position is sufficiently large, and that the non-pecuniary cross-border externalities is sufficiently valued.

This study dwelt on the static and multi-game solutions. It will make an interesting study to see a paper extending the provision to a transitional phase in a dynamic model. Telecommunication has transformed the world as we know it. Therefore studying the change in the volume and quality of trade vis-a-vis the continental economic integration would open up new frontiers

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