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TRADE WITH THY NEIGHBOUR

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Contents

NEW! A 2010 journal article quoting this policy as appropriate to two African countries

1. The advantages of trading with neighbouring countries

The easiest **market access** for most finished goods is in countries that geography puts nearby; but history, political unfriendship, colonial rules and a host of other reasons might have prevented to seize this natural advantage, that has to be nurtured with transport infrastructure and appropriate policies.

Small and medium-sized enterprises are more at ease if the market is near, just few kilometres away from their own productive locations. A much **wider business community** can take profits from trade if **proximity cross-border trade** is high on the agenda of broadly defined trade decision-makers.

Proximity creates the kind of relative bilateral monopoly that might bring to **economic integration** on equal foot, with deep reciprocation and internalization of bilateral externalities. Marginalized sub-national regions and communities might thrive because of the activation (or re-activation) of legal trade across the border.

The present paper provides an overview of the **goals** and the **effects** of **a new trade policy** whose main consequence is not only the increase in your country's trade but, even more importantly, the emergence of the **integration pattern of international relationships** out of the hierarchical world we have described in this paper.

2. What's cross-border proximity trade?

Borders separate countries by law and firms react by mental and factual decisions. Many national firms have business routines to distribute their products all over their country, with no explicit exports, which would imply a burden of new decision-making, new responsibilities, new risks. As an effect of the cumulative decisions of many firms, even if two cities are near just few kilometres, the products and brands on the shelves can be very different, if the cities are situated in the opposite split of a border.

Even for similar categories of goods, prices in the two cities can be fairly different, since, although retailers tend to adjust to local conditions (income level, income distribution, competition, etc.), they buy from national businesses that have (in relatively cohesive countries) nationwide pricing lists.

In short, borders artificially create a different supply at a very limited distance, with the cost of transport be much lower than the differences in prices, especially if bulk transport of many items is taken into account.

The potential for trade is thus extremely high: profits can be done by intermediaries and - even more so - by retailers operating across both sides of the border.

Productive units located there might find easier to export a few kilometres away than to send products to the capital city of their own country. The minimum size of export lot can be quite small and delivery frequent. All this makes proximity trade a very interesting business for SMEs.

Even if one country is visibly richer than the other, proximity trade is mutually beneficial, because, usually, the former will offer a wider variety of goods with superior quality and the latter will offer lower prices (and attractive productive locations). Accordingly, import and export flows will start from both sides.

Every transport **infrastructure** better connecting the two nearby regions and cities will be helpful for both, further reducing transaction costs.

Being so near, the two regions might be quite similar in consumption habits; this means that frequent "*connaisseurs*" will distinguish even minor features of horizontal differentiation in products [1].

Gravitational models of international trade consider the total trade between two countries directly proportional to their GDP and inversely proportional to distance (or a power of it, depending on the specification of the model). Accordingly, **the unique way** to have a **large trade** between two **poor** countries is that they are neighbours (so that **distance tend to zero**).

If all this is true, why can actual trade be lower than this high potential?

3. Barriers in cross-border trade

Cross-border trade can be dampened by the border itself as a legal constraint. There might be complete closed border because of war or of a legacy after war.

Protectionism can raise prohibitively high tariffs and duties, so that it makes trade unprofitable.

In all these situations, the traditional arguments in favour of free trade as a peace facilitator enhanced by the international community hold their power. Cross-border trade can thus become a part of the "peace dividend" after a conflict or the material basis of peaceful relationships.

Less formally, obstacles to trade can be nested in cumbersome custom procedures, insufficient phyto-sanitary premises or other elements leading to a de-facto closed border.

In all these cases, smugglers will try to put in place an illegal cross-border trade. Contrary to the legal one, this "market" is highly risky and exhibits monopolistic hyper-profits, which can be channelled into corruption, with the consequence of a weakening of market structures, public interest, tax revenue, health-relevant controls.

Legalizing trade means, for instance, to provide (at least) the residents in the two neighbouring regions with proper visa, to establish public fairs where the exchanges can take place competitively, to streamline transparent custom procedures.

Ethnical minorities are often located at the border of a country, possibly having particular links across the border. Accordingly, nationalistic states might restrain from supporting cross-border trade in the myopic expectation that this will weaken the identity of the minority. The more so, if the other state is dominated by (or has a liberal policy toward) this ethnic group.

In a world where peace and prosperity should be the goals and the qualities that characterize the inter-state relations, this is more and more unsustainable. The states are strong if their citizens are happy and ethnic minorities find their place in the national economy, possibly bringing their special relationships with neighbouring countries to a level which is economically fruitful to all.

By allowing and fostering proximity trade, a state demonstrates its integrity, its strength, its openness. This kind of trade increases overall exports, international integration, peaceful relations with neighbours. When borders can be freely crossed, private organizations can operate, thus they will stop pressing their central state to intervene. Peaceful means can be used to reach aims that in other contingencies might have pressed towards hostile activities or claims on border localization.

Bringing under a legal umbrella all economic activities allows to the states to enforce regulations that bring all subjects into a condition of relative parity.

Less dramatically, a lower than potential cross-border trade can be due to insufficient trasport networks linking the neighbouring regions. This is particularly frequent because of the bounded-rational decisionmaking in the location of infrastructure from a centralized perspective, which prioritises the links between major cities within the country.

International trade is then delegated mostly to **seaports**, with **little interest in long land borders** where only small towns are located.

A second reason for reduced trade at the border is **language**, with national or regional education and training as a key response.

All this means that proximity trade is an interesting issue to be careful evaluated in both regional and national terms.

4. A quantitative assessment

In 2003, international trade between **countries sharing a land border** was about the **24% of total world trade**, in a 99-countries exercise coherent with what described here.

This particular kind of trade was **more balanced** than between non-neighbours, with trade deficit ammounting to 14.1% of total trade in the former case and to 15.9% in the latter [2].

In structural terms of the quality of the relationships implied by trade, **cross-border trade is much more conducive to integration** than long-distance trade.

To precisely assess this, we apply a methodology we developed in previous papers like this and this other. Summarizing, trade relations - between a first country A and a second country B - can be characterized by four conditions, each of which can be "true" or "false":

1. "For B, A is a major export destination"

2. "For B, A is a major import source"

3. "For A, B is a major export destination"

4. "For A, B is a major import source".

These propositions are logically independent, since each one can be true or false independently from the values of the others.

For each proposition, we build a binary variable that will take the value of 1 if the proposition is true and zero in the opposite case.

The "binary description" of a two-countries pattern can be obtained simply by nearing the four binary variables in the same order as we presented them. For instance the binary description 1100 means that, for B, A is both a major export destination and a major import source while, for A, B isn't important. We shall call this relationship the "dominance" of A over B.

In naming these patterns, we care about the situation of A against B, so e.g. we call "dependence" the situation in which A is completely weaker than B.

These are the exhaustive list of the 16 patterns:

Name	Binary description	Qualitative description
Absence of relationships	0000	The countries "ignore" each other
Source dependence	0001	B is an important provider for A
Destination dependence	0010	B is an important market for A
Dependence	0011	B is very important to A, but the reverse is not true
Source dominance	0100	A is an important provider of B, but A can ignore B
Source integration	0101	They both need each other as providers
Mono out-integration	0110	One flow is important for both: the exports of A to B
Dependent source interconnection	0111	A depends on B, but B needs A's supply as source
Destination dominance	1000	A is an important destination for B, while A can ignore B
Mono in-integration	1001	One flow is important for both: the exports from B to A
Destination integration	1010	They both need each other as exporters
Dependent destination interconnection	1011	A depends on B, but B needs A market as destination
Dominance	1100	A is very important to B and can afford to ignore it
Dominant source interconnection	1101	A is very important to B but A needs B as a source
Dominant destination interconnection	1110	A is very important to B but A needs B as a destination
Integration	1111	They need each other on an equal foot.

"Integration" - as a word appearing in more than one pattern - means that there is reciprocity. "Interconnection" means that there are three 1s, i.e. there is a strong relation between the two countries. "Mono" means that the same flow of goods and servicies is important for both.

Now, let's see what happens if - out of a large number of countries - we select the sub-set of "neighbours" defined as countries sharing a land border.

In the overall matrix for 2003, the **absence of relationships** dominates with 4217 occurrences (87% of the total), whereas this percentage **shrinks to just 22%** among neighbours.

Although "most countries live far away from each other, possibly maintaining kind diplomatic relationships but activating just minor trade exchange flows", the reverse is true for countries sharing a land border: about 78% of relationships are non-absent, with the few exceptions (labelled as "0000" in our notation) that turn out to be highly significant in political terms, as characterized usually by dictatorships, opaque regimes, wars, etc. [3].

The distribution of non-absent relationships is deeply influenced by neighbourhood. **Integration** relations ("1111") are just the 2% of all relations between non-neighbours but as much as **11.6% between neighbours**.

If you are looking for integration, first look at your neighbours.

This is confirmed by the jump of the symmetrical weak integration pattern of "Mono integration" ("1001") from 1.3% to **5.7%**, respectively.

Asymmetric "rich" relationships as Interconnections can flourish between neighbours as well. In particular, "Destination interconnection" ("1110") rise from 0.9% between non-neighbours to **5.36%** between neighbours. "Source interconnection", however, falls from 1.3% to 1.1%.

The **most widespread relationships between neighbours** is **Dominance** ("1100") - and its mirror Dependence ("0011"), with 36.8% of all non-absent relations between neighbours instead of 36.4 between non-neighbours.

In other words, relations with neighbours are not always "rosy" but they are always relevant for the policy-maker.

A pro-active consensual approach to proximity international trade can help, if properly designed and carried out, to strengthen the role and the voice of each country, be it poor or rich.

For instance, small / poor countries might aim to integration with a sub-national region of a stronger neighbour.

The current situation is however extremely differentiated. There are "enclaves" with extremely high level of trade with neighbours (which in part reflects the difficulty of reaching new markets) and open countries which fully exploit the opportunity for exchanges with neighbours.

Country	% exports to neighbours out of total exports (2003)
Mexico	84%
Canada	83%
Andorra	75%
Belarus	71%
Czech Republic	59%
Austria	56%
Mongolia	55%
Bolivia	48%
France	48%
Poland	47%
Nepal	47%
Belgium-Luxembourg	43%
Switzerland	40%
Netherlands	48%
Germany	38%
Slovenia	36%
USA	34%
Argentina	31%
Spain	30%
Slovakia	29%

Source: our elaboration from UN Comtrade data.

Island states exhibit, by definition, a 0% land-border trade; however, surprisingly tiny amounts of it occur also for countries sharing (even long) land borders with neighbours, as Venezuela (4%), Brazil (10%), Hungary (13%). As you can see, there is a wide room for improvements.

Depending on starting conditions, appropriate policies can boost proximity trade in a balanced way so to improve the quality of the relationships, as it effectively happens with bilateral import promotion.

5. Conclusions

More cross-border proximity international trade would improve the quality of the relationships among nations, in the direction of more integration. It would boost marginalized regions and communities, "healing" the wounded that borders inflict to the texture of the world.

It would enhance a vibrant private economy with a key role for Small and Medium-sized Enterprises, seizing market and productive opportunities at hand. Consumers would enjoy larger choice bundles with a wide scope for horizontally differentiated traditional goods.

If you are already satisfied with the level, dynamics, and structural quality of cross-border proximity trade of your country, fine. If not, a tailor-made strategy and action plan based an accurate analysis of the hindering and mutation factors is called for.

NOTES

[1] In other words, our perspective assumes **heterogeneous bounded rational agents** such as firms using rules of thumb and consumers ordered in terms of cognitive competences, in a market dominated by product differentiation, imperfect competition, economies of scope, scale and variety.

[2] Needless to say, national statistics are just an approximation of the kind of data necessary to precisely fit the local nature of proximity international trade.

[3] "Difficult borders" for which neighbouring countries exhibit an "Absence of relationships" pattern ("0000") - automatically computed through our methodology - are the following:

Country	**Neighbour**
Albania	Macedonia
Algeria	Tunisia
Algeria	Morocco
Belarus	Latvia
Brazil	Colombia
Bulgaria	Romania
Bulgaria	Macedonia
Colombia	Panama
Costa Rica	Panama
Croatia	Hungary
Egypt	Israel
Ethiopia	Kenya
Finland	Norway
Greece	Turkey
Hungary	Slovakia
Hungary	Slovenia
India	Pakistan
Iran	Pakistan
Israel	Lebanon
Israel	Jordan
Malawi	Zambia
Norway	Russia
Oman	Saudi Arabia
Poland	Slovakia
Qatar	Saudi Arabia

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