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Economic Integration: A Review of the Concept

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1.1 Introduction

Liberalization of economic policy, making countries lower trade and investment barriers through out the world, has helped increase the flow of goods and factors crossing national boundaries through the world paving the way for the world to integrate closely. Besides, another trend in the world has been the liberalization of the economic policy carried out on the basis of regional integration arrangements (RIAs) in a group of countries generally located in a particular region. There has been a substantial increase of RIAs particularly in the 1990s, which has attracted trade theorists and policy makers in the recent decade. Both routes increase the country's integration with outsides at two different levels: the first one, through unrestricted integration with the rest of the world and the second one through restricted integration with the countries with which the integration arrangement is in force. The concept of integration as it is being used embraces many different meanings and, following from that, diverse views are integrated into the definitions of integration. The discussion of the concept has attracted attention since Viner's (1950) exposition on customs unions. Since then the subject area of study under economic integration, has developed a relatively vast body of literature. It is concerned, in the main, with economic issues of regional integration arrangements[1]. Since the 1950s when the theory of economic integration began its development, although most of the issues dealt with were customs union centered, they now go beyond the customs union framework. Diverse conceptual issues relating to economic integration are discussed in detail in this paper. In the main it focuses on an analysis of the concept of economic integration as it is related to regional economic integration. Firstly, it describes the meaning and tries to put economic integration in perspectives. Secondly, it elaborates on the types of economic integration arrangements. Thirdly, it describes briefly the present debate on regionalism. Finally, it elaborates on new trends associated with the concept, the agglomeration and open regionalism, followed by concluding remarks.

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[1] Integration issues pertaining to the world -wide movements of goods and factors of production are part of the real theory of international economics.

1.2 Integration: Meaning in the Context of Economics

1.2. 1 Integration: the Basic Idea

The meaning of the term 'integration' in common parlance is to unify parts into a whole or the setting of parts belonging to a larger aggregate. Different social science disciplines have different meanings attached to this term. For example in disciplines such as sociology and political science, the term has its meaning specific to the discipline, in which social integration and political integration respectively are closely associated with theoretical discussions. "Social integration is one of the richest and most classical concept in Sociology" (Calderon, 1995: 50) However, the concept was defined differently on the basis of different thoughts of schools of Sociology. Therefore, there is a wide range of differences in meaning of the concept in this discipline. Further ".... any form of integration implies differentiated, conflictive and socially ranked relations." (Calderon, 1995: 51). The concept of social integration too tries to explain the process of the inclusion and delineation of elements of society. Inclusion referring to social integration embraces the process of being belonged to by elimination of barriers both legal and otherwise and discriminatory mechanism such as sex, age and race in markets in the society, in public and private institutions (Calderon, 1995: 52)

Political integration, however, looks at political implications of the economic integration process in making a common economic space. Hence, its focus is centrally placed on the institutional consequences of such regional integration arrangements (RIAs). In essence the concept of political integration "deals with the need to establish, along with the integrated space, an institutional center capable of regulating the functioning of the economic relations within the space" (Orantes, 1984: 54). Unlike the economic aspect of the definition, this does not consider stages although it implies a gradual process. Further, it is intertwined with economic integration and, as it moves along, it indicates that more power is transferred to a common institution.

The term integration has a relatively a long history of use in the social sciences and humanities. The ideas that emerge show that there are elements common to all social sciences and humanities disciplines including what is discussed under economic integration. The term 'economic integration' embraces a variety of notions. It is used to mean the absorption of an enterprise into a larger one, which is referred to as vertical and horizontal

integration. It also contains a spatial dimension in which it refers to regional integration within a national economy. However, the term economic integration is explored here with respect to international economic relations involving the combination of two or more sovereign states in one entity. Hence regional economic integration is referred to as economic relations involving two or more countries in a region of the world.

1.2.2 'Economic Integration' in Perspective

The term economic integration is of relatively recent origin although in other disciplines, for example in humanities and social sciences, it has had a relatively longer history in use than in economics. Myrdal (1956: 9) points out that the term integration had been found within the exclusive domain of sociologists and social anthropologists to explain stable social relations within a community confined to a particular place, prior to it being used in economics. This term had not been in use in international trade or customs union literature until the 1940s Machlup (1977: 3). However, different terms like, cooperation, amalgamation, fusion, unification or often similar terms in the literature of international economics had been used to refer to the same phenomenon even prior to that period. This term "economic integration" was used for the first time in economics in the context of industrial organizations to refer to the combination of firms (Machlup, 1977) quite apart from the context in which the modern use of the term developed. Hence it could be considered that its use is relatively recent[2].

"As a term, the integration of economies of separate states is not found anywhere in the old, chiefly historical literature on the economic interrelationships between states, nor in the literature about customs unions (including the German Zollverein 1834-71), nor in the literature on international trade prior to 1940s." (Jovanovic, 1992: 4).

Since the beginning of the discussion on economic integration during the post World War II period no consensus has emerged among economists as to what exactly is meant by economic integration. Tinbergen is among the

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[2] Myrdal indicates that "the term "economic integration" is one of the expressions that emerged after the Second World War as a new popular banners in the political discussion of international questions" (1956: 9).

few early theorists to provide a definition. His definition deals with the negative and positive aspects of integration where the former is defined as being the elimination of discriminatory and restrictive institutions and the introduction of freedom for economic transactions, while the latter is defined as being the adjustment of existing, and the establishment of new policies and institutions endowed with centralized and cohesive powers (1954: 122). Elimination of impediments to, or alternatively elimination of negative elements to integration, which hinder free trade, leads to better division of labor within the bloc, while measures to ensure the process of free competition and to remove distortions in that process are related to positive integration. The negative side of integration deals with aspects like removal of tariffs and non-tariff barriers, while the positive side deals with aspects like the introduction of common economic policies, and the harmonization and coordination of existing ones. Tinbergen (1954) introduced two terms-negative and positive integration - to distinguish the importance of removing existing barriers (negative integration) from creating equal conditions so as to enable the functioning of the integrated parts of the economy (positive integration). Hence positive integration involves government policies of a complex nature while negative integration is relatively direct and simple, and include making government policies towards deregulation and liberalization in order to remove obstacles. While negative integration is based on agreements, positive integration takes the form of political and bureaucratic procedures rather than involving law (Molle, 1990: 11-12).

Destruction of both social and economic barriers between countries is considered a process through which according to Myrdal, integration could be achieved.

> "The economy is not integrated unless all avenues are open to everybody and the remunerations paid for productive services are equal, regardless of racial, social and cultural differences" (Myrdal, 1956: 11)

This idea embraces a wide range of economic and non-economic aspects of integration. Economic integration is interwoven with social relations if it is confined to a country. To capture its whole meaning it needs to be looked at from a broader social perspective. The importance of social factors in the destruction of economic barriers was thought of as a significant element. This definition includes ideas common national and international

integration. This idea of integration is interwoven with international egalitarianism. However, underlying factor price equalization requirements, exclude several other important economic integration schemes such as free trade areas and customs unions, in which freedom for movement of factors is not present. Artificial barriers such as tariffs, non-tariff barriers, exchange restrictions and restrictions on factor mobility along with restrictions arising from various economic policies form barriers to integration between countries whereas these are not present within a country[3]. Hence this definition captures several other elements which are not included in the meaning of economic integration in its current sense.

The term 'integration' has slightly differing meanings in different branches of economics[4] and the term 'economic integration'[5] does not have a clearly specified meaning even in the literature of international economics although it represents several interrelated ideas to denote various forms and levels of economic relationships and tendencies, the term 'economic cooperation'[6] has often been interchangeably used in the early literature to mean economic integration, although slight variation of the qualitative and quantitative nature in their meanings was distinguished by Balassa[7] (1961a). Further, the

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[3] See for details Balassa (1961b: 3-4) as to why it is not necessary to include national or social dimensions into a definition of economic integration.

[4] In the theory of industrial organization, for example, it refers to combining firms - vertical and horizontal integration- through various schemes. The theories concerning regional economics deal primarily with issues associated with intra and inter regional imbalances in development in a country.

[5] Meaning of this term included several facets. "Movement of goods, services, people, capital funds, and moneys across natural or political frontiers are what interregional and international economic relations are all about - and all of these movements are part and parcel of economic integration" (Machlup, 1977: 43).

[6] The Preface of Jan Tinbergen's *International Economic Integration* published in 1954, indicates that its previous edition published in 1945 carried the title *International Economic Co-operation.*

[7] "Whereas cooperation includes actions aimed at lessening discrimination, the process of economic integration comprises measures that entail the suppression of some forms of discrimination" (Balassa, 1961a: 2).

term economic integration in the context of its modern meaning embraces the areas of economic cooperation as well.

> "Economic integration, and economic cooperation have been used interchangeably referring to the same phenomena. However, the term regional integration has acquired several quite technical definitions while regional cooperation is applied vaguely to any inter-state activity with less than global participation and which is designed to meet commonly experienced needs. The definitional meaning of the term integration involves some ambiguity. Some authors include social integration in it while others subsume different forms of international cooperation under it" (Asante, 1986: 34).

Yet another interchangeable occurrence is in the use of terms like, 'openness', 'integration', and 'interdependence' to describe the existence of various economic interrelationships among countries although each of them represents different ideas and they are related closely with each other (Panic, 1988: 3-4). The discussion of meaning of economic integration excludes any integration tendencies prevailing or actions taken towards it in the non-market framework[8] particularly because such arrangements in a non-market framework are confined to actions of an administrative nature and completely exclude the significance of the price mechanism. This aspect is clearly represented in the early literature where the assumption of the free market is indispensable in the classical trade theory. Hence "economic integration is basically the integration of markets" (Molle, 1990: 10).

In a static sense, economic integration is meant to represent a situation in which national economic frontiers no longer become walls of separation but act in unity in a larger entity of a region[9]. In a dynamic sense it means

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[8] For example, the countries belonged to the former Council of Mutual Economic Assistance (with the membership of former Soviet Union and its communist allies) also had a certain form of integration scheme within a non-market framework. However, it disappeared with the collapse of the Soviet Union in 1991.

[9] The assumption of free markets in relation to integration has been integral during post war years. This was formally incorporated into the GATT Article XXIV in which the 'elimination of discriminatory treatment' among contracting parties was the objective of the article.

gradual elimination of national economic frontiers[10]. This process enables the formally separated national economies to form one regional unit (sub set of the world) in which specified common space is created. Economic integration describes various forms and stages of economic links between two or more formally separate national economies. It could describe a level of integration at a particular point of time or the process it takes to reach a particular level of integration. The dynamic (ie. process) aspect indicates how economic entities gradually merge into a larger whole. It does not, however, include any situation where social or locational differences are taken into account within a national economy, thus making the economy integrated at national or macro level. Nor does it embrace the meaning of any integration denoted in a specific branch of economics i.e. industrial organizations, more precisely in microeconomics. Accordingly in its subject body, it has to do with facets of economic relationships between countries and, hence, regional economic integration, or international economic integration or merely economic integration interchangeably refer to the same phenomena at present.

Free trade in products and unconstrained movement of factors constitute first best policy for the world as whole, while the basis for the second best is found where there are deviations from the former. In essence, a part of the continued justification of the basis for regional economic integration arrangements is derived from the prevalence of distortions in the international economy. Hence the second best policy is an integral part of the analysis of economic integration. As far as its theoretical foundation is concerned, economic integration belongs to the body of knowledge of the pure theory of international trade; more narrowly to a branch of it which analyses international economic issues pertaining to economic relationships between countries.

Various theorists give different meaning to the term. However, movement of capital and labour and products, all three, or two or one of them, across national frontiers, has been one of the salient aspects of 'general' economic integration compared with 'sectoral' (*partial*) economic integration. Sectoral economic integration refers to particular arrangements in connection with the coordination or management of a specified sector or sectors (e.g. mining,

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[10] Economic frontiers in this paper are considered to be barriers to the movement if not otherwise indicated, of products, factors and the forms of incompatible national economic policies.

power, transportation etc.) of the economies of a group of countries. In case it is not specifically mentioned, international economic integration refers to the 'general type'. The meaning of the term economic integration is also associated with the mobility of products and factors in the context of a non-discriminatory framework across national boundaries within the bloc, whilst discrimination by the members against non-members of the bloc is also built into it. Certainly the general type of economic integration is related to all economic activities within an RIA, and not limited to a particular sector or industries.

Regional economic integration is one of the mechanisms, which will increase welfare although it is not the most efficient and is not optimal for the world as a whole. Such an increase in welfare may be experienced by each country individually, by the group as a whole collectively, or some countries within the group may experience an increase while others do not, within the same group. It is also a strategy for development since economic activities could be stimulated at a faster rate by its presence. However, it is not an objective in itself; but acts to serve an ultimate objective like the welfare of all constituent countries (Molle, 1990). Integration is not a part of the objectives of national or international policies. The term however, has to be related to the objective of economic policy. The real objective of integration, therefore, is related to raising the levels of real income of the residents of the country. Integrating commodity and factor markets is generally regarded as one of the means of reaching such objectives by promoting economic efficiency. In this context, the term integration can have different meanings depending on where it is used - national, regional, global. It can be applied to markets for products, factors or technologies. Trade liberalisation increases the commodity market integration (Lloyd, 1992:35-37).

With the reduction of barriers to trade, the resulting increase of trade will lead to increased economic integration and as trade between countries increases, the degree of a country's openness rises. Economic integration may possibly include varying degrees of cooperation between two or more countries in areas of interface other than trade - factors, payments, fiscal and monetary policies, welfare policies, and coordination of investment plans. However, as the degree of economic integration rises, the effectiveness of the national macro economic policies is reduced. This is because actions of other economies will have effects on the national economy as more and

more factors and products are becoming mobile among them (Schwidrowski, 1991:85).

The integrative process can take two avenues; one which moves to a larger extent along price mechanisms and the other to a larger extent along decisions away from price mechanism, for example, through a central planning authority. These two aspects of integration are two different methods, each with a distinct nature. The concept of integration has always been discussed in the context of market mechanisms. However, the other mode also integrates countries based on the decision by officials of the countries involved, or *dirigiste* integration, not based on the country's comparative advantage or benefits of economies of scale. Abolition of barriers and the resulting trade pattern reflects the comparative advantage exhibited by members according to the Ricardian analysis. In essence, economic integration in the competitive market context tries to create ideal competitive conditions for various agents in the economy; producers, consumers and traders within the membership (Ghai, 1984). In centrally planned economies however, production, consumption, trade and prices are determined in the plan and trade is not reflective of the comparative advantage but reflective of the requirements set out in the plan. In this context barriers described in the market economy context are irrelevant since trade is either a monopoly of the state or determined elsewhere outside market forces. Therefore, quantitative restrictions decided upon by the plans are the method by which international trade is determined. Hence trade integration in this context is achieved through the coordination of plans among the members.

Economic integration is concerned with allocative efficiency, having a special reference to the spatial aspect according to Robson (1987: 1). For him, full integration necessitates two conditions to be met - (a) freedom of movement for goods and factors, and (b) absence of discrimination between members of the bloc. Yet another requirement for full integration is that resources need to be allocated by the price mechanism, thus ruling out possibilities of achieving that state through other means[11]. Accordingly, integration schemes based on administrative mechanisms like the Council

[11] This definition rules out trade based on counter trade arrangements as well.

for Mutual Economic Assistance[12] (CMEA) or more commonly known Comecon did not have any possibilities for full integration among the constituent members.

Different properties have been used to provide a meaning to this concept in the literature based on order and levels of integration. This takes several stages of ascending order of integration. It has been categorized into at least five major stages namely (a) free trade areas, (b) customs unions, (c) common market, (d) economic union, and (e) total economic integration.

1.3 Types of Economic Integration Arrangements

Erich Schneider as mentioned by Machlup (1977) had indicated two extremes of possible integration between two or more countries. A country, at one extreme, lies in complete isolation and at the other, in perfect integration. In between, there are many different degrees of integration. Economic integration schemes can be categorized broadly into partial and total; the former being the integration of a selected sector[13] or sectors of the economies, interchangeably being referred to as a functional or step by step approach to economic integration, while the latter encompasses simultaneous integration of all sectors[14] or the entirely of the economies involved. Advocates of the functional approach see as its merit the flexibility in bringing countries into an agreement since some countries find it otherwise difficult to take all sectors into account across-the-board, whereas advocates of total (ie. all sectors) integration indicate that the simultaneity brings compensating changes and synergy into integration process. Further, adjustments in one sector alone are self-defeating amid the existence of distortions in other sectors at least until the next sector/s are brought in. Since some industries contract, while others expand in response

[12] Now defunct, CMEA was established in 1949 between former Soviet Union and its communist allies in Europe, later joined by Mongolia, Cuba and Vietnam.

[13] The European Coal and Steel Community is commonly cited as an example for sectoral integration for its fair degree of success. It faced several difficulties, however, in the areas of transportation policies, fiscal and social aspects.

[14] It should be clear that sectoral integration in particular sector/s of the economy can take place within any schemes described here. For details see El-Agraa (1988: 2).

to adjustments of relative prices and resources allocation, integrating all sectors simultaneously proved to be appropriate (Balassa, 1961a).

Economic integration schemes differ widely in scope and expectations. reflecting the motivation behind the scheme. For analytical purposes, it is necessary to distinguish between various forms of integration[15]. In accordance with the classification of Balassa (1961a) several levels or stages of integration[16] may be identified in increasing the order. as:

(i) Free Trade Area (FTA): Under this arrangement member countries abolish tariff and quotas on imports within the group while retaining their own restrictions on imports from the rest of the world (ROW). This could lead to a situation where, products of ROW enter the member country with high tariff through a member with low tariff in FTA. This situation is, according to Balassa (1961a), referred to as trade deflection. In order avoid trade deflection, rules of origin should be in place to administer the tariff-free treatment only to products largely or wholly produced in the FTA.

(ii) Custom Union (CU): CU takes yet another step over and above what is found in an FTA. Member countries apply a common external tariff vis-a-vis the ROW.

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[15] Some see a very limited relevance of the identification of various types of integration schemes. "One of the overall conclusions is that the so-called *types* of economic integration are appropriate only for textbook exposition purposes since they do not represent any single actual scheme. (El-Agraa, 1988: 332)

[16] Lipsey (1968) has introduced six integration schemes, namely (a) preferential tariff systems (lower level of tariff internally than externally); (b) free trade areas (zero tariff internally); (c) customs union (common external tariff); (d) common market (free movement of factors of production); (e) economic union (common monetary, fiscal and other policies); (f) complete economic integration (single economic policy). (a) is not accepted under GATT . Type (f) indicates a single economic policy although in reality it is hardly possible. Yet another slightly different categorisation of integration schemes are available in El-Agraa and Jones (1981: 1-2), Molle (1990 :12-13), Javonovic (1992: 9). They include a few other aspects while generally adhering to the categorisation of Balassa (1961a).

(iii) Common Market (CM) : CM goes further than a CU to allow free movement of factors of production-capital and labor. At this stage restrictions on both trade in products and factor movement are abolished.

(iv) Economic Union (EU): This is a CM with some degree of harmonization of national economic policies.

(v) Total Economic Integration (TEI): An EU with unification of monetary, fiscal, social and counter cyclical policies is considered as TEI. Besides, it needs a supra-national authority to coordinate and implement its decisions. Table 1 summarizes the basic features of various forms of integration schemes described above.

EU and TEI seem to be the same and difference are only in detail (Javanovic, 1992). FTA and CU make product market integration possible while CM adds and facilitates factor market integration within the bloc. The first three stages of the above classification seem to refer to market integration while the latter two have to do with policy integration. However, in practice the first three stages also need some form of policy integration[17] for stabilization purposes. In reality, the RIAs are diverse in nature and may not directly conform to any of the schemes discussed above. Therefore the classification represents only a partial reality though useful for the purpose of analysis (Hine, 1994: 235).

[17] In the first three stages, it is necessary to look into certain types of policy integration that should be in place along with the requirements desired in each. For instance safety regulations in an FTA, commercial policy in a CU, social and monetary policy in a CM are required for stabilization purposes (Pelkmans, 1980).

Table 1

Basic Features of Economic Integration Schemes

Basic Feature of RIA	Type 1 FTA	Type 2 CU	Type3 CM	Type4 EU	Type5 TEI
Removal of tariffs and quantitative restrictions between member countries	Yes	Yes	Yes	Yes	Yes
Common external tariffs with ROW	No	Yes	Yes	Yes	Yes
Freedom of movement of factors	No	No	Yes	Yes	Yes
Harmonization of economic policies	No	No	No	Yes	Yes
Complete unification of economic policies	No	No	No	No	Yes

Factors that drive independent countries into forming a RIA are diverse[18] are not similar in nature, and they differ from one RIAs to another. Further, all dimensions of the concepts of RIAs are not clearly specified and, in common parlance, understanding an RIA means comprehending a wide range of economic and other linkages between separate countries. Despite difference between them, all types of economic integration arrangements exhibit three major characteristics:

(1) the suppression, in certain matters, of discrimination among the members;

(2) the maintenance of discrimination against the rest of the world in various respects;

[18] There is a host of factors attributed to such formations. See for details Molle (1990) .

(3) the conclusion of agreements among the members that are intended to have a lasting character, and that limit the unilateral use of certain instruments of economic policy" (Robson, 1987: 2).

Besides, all forms of integration reduce the freedom of actions in the member countries' ability to maneuver its internal policies. The higher the form of integration, the greater the restrictions imposed on national policies (Molle, 1990: 14).

Inadequacy of the current terminology of various stages of integration in the European Community context, particularly the 'Single Market of Europe' is questioned by Lloyd (1993). According to Lloyd (1992) and Flam (1992). The Single Market is the place in which the Law of One Price (LOP) prevails. It means that in a competitive market, there is one market price for product or a factor of production after making an allowance for transport and other transfer costs and there is no room for arbitrage. This implies, further, the removal of both border and non-border barriers to trade in products and movements of factors of production, and harmonization of economic policies which includes *inter alia*, national treatment of foreign owned factors of production.

Hence Lloyd (1992) considers another stage of economic integration in the context of recent developments in the European context; that is a single economy. He defines it as "an economy with no differences in laws and regulations within the economy and a unified fiscal and monetary system throughout the area" (1993:37). However, he has not dealt with the complicated question of sovereignty or else this definition implies that countries have pooled sovereignty under one country or renounced it in favor of a created sovereignty (multi-nation) (for example what is available in the form of governments in countries like Canada, US or Australia). However, such a situation needs more aspects to be dealt with over and above and the subject of economic integration. Disappearance of political or social frontiers is much harder to achieve than economic frontiers between nations and needs a longer time than has thus far been seen by the European Union.

1.4 Effects of Economic Integration

Irrespective of the actual motives that drive integration arrangements, both ex-ante and ex-post economic analyses of economic integration are undertaken to:

(a) Identify the economic effects and issues relating to such formations, and
(b) Quantify the economic effects of such formations.

Identification of economic effects is of course guided by theory whereas quantification of such economic effects belongs to empirical work.[19] Empirical studies measuring effects of economic integration have dealt basically with three issues related to the RIA arrangements described above :

(a) The extent to which economies are integrated,
(b) The aggregate effects of integration on trade and other variables influencing welfare, and
(c) The distribution of costs and benefits of economic integration

As Mikic (1998) points out, there are both conceptual and practical problems of a major kind that make evaluation of the effects of integration difficult. Even though the availability of computable general equilibrium (CGE) models has improved the situation, the estimation of the actual trade creation attributable to integration is very difficult. Even if that were done, calculating the welfare changes is also difficult because domestic prices do not change by the same magnitude as tariff changes; ex-ante studies suffer from elasticity estimates that need to be extrapolated to the post-integration situation; ex-post studies have to create a hypothetical counterfactual situation; models with scale economies are very sensitive to model specification; and all these issues are further complicated by the difficulties of isolating and measuring static and dynamic effects.

[19]The divergence between theoretical developments and empirical work that is often found better exemplified in the study of economic integration than in any other area in economics (Mayes, 1988).

Nevertheless there are a large number of studies on integration arrangements (for a reviews see Srinivasan, Whalley and Wooten, 1993), with the most sophisticated studies focussing on NAFTA, and particularly on EC. While the results vary greatly in terms of the magnitude of the welfare effects of the integration arrangements, the majority indicate welfare gains rather than losses. Nevertheless, even if RIAs appear to generate some welfare gains for their members, particularly in the short run, the issue of whether the long run effects of RIAs are welfare improving or not remains hotly debated. The major issue here is whether the tendency for RIAs to turn inward and erect barriers to the ROW will dominate, thereby undermining multilateral moves towards global free trade and integration,, or whether RIAs will gradually broaden to include other countries so that finally global free trade and integration will be achieved through an amalgamation ofRIAs[20]

1.5 Present Debate on Regionalism

Two powerful forces reshaping the world economy at present are: (a) globalization acting to integrate the global economy, which is already functioning as a system in which national economies are interdependent, and (b) the resurgence of regionalism promoting regional specificities within the global economic system (Hine, 1992). This in part, has evoked a new debate: are these two complementary, or are they in conflict with each other? In international economic policy circles, in terms of approaches to greater economic integration, this question has been posed in terms of multilateralism versus regionalism. The concept of regionalism is distinguished from that of regionalisation: regionalism is defined broadly as a preferential trade agreement among a subset of nations, signifying a process involving policy actions by governments to act together at a regional level (Bhagwati, 1993), while regionalisation is the process whereby' regions are becoming more significant in global trade and investment.

[20] For arguments on both sides see Krugman (1993) and Bhagwati and Panagariya (1996).

The present debate on regionalism is due to several reasons. The progress achieved by EC in European integration, and in particular the conversion of the most ardent proponent of multilateralism, USA, to an active promoter of RIAs, have been the main factors that have led to a resurgence of interest in RIAs.[21] The, primary reason for the conversion of the USA to regionalism is claimed to be its unhappiness with the slow progress towards greater liberalization made in the multilateral negotiation processes, particularly at the Uruguay Round of trade negotiations (Levy; and Srinivasan, 1996).[22]

The current debate about the relationship between regionalism and its role in fostering wider economic integration is in the main associated with two divergent views focussing on its impact on global trade liberalization:

(a) Regionalism is a step in the direction of multilateral liberalization of world trade or it facilitates it;
(b) regionalism is an obstacle to the multilateralisation of international trade, or will fragment the world trading system.

(a) One view is that the current phase of regionalism is a challenge to the multilateralism (ie. stumbling block) at the heart of WTO efforts to achieve global trade liberalization (Bhagwati, 1993; Bhagwati and Panagariya, 1996);

[21] The USA's promotion of regionalism is seen in several initiatives it has taken in recent years, such as: the initiation and promotion of the Caribbean Basin Initiative (CBI); the US-Israel Free Trade Agreement (1985); the Canada-US Free Trade Agreement (CUSFTA) of 1988, and its extension to Mexico through the North American Free Trade Area (NAFTA) in 1991; and participation in Asia Pacific Economic Cooperation (APEC) since the inception in 1989. Further, the Enterprise for the Americas Initiative (EAI) declared by President George Bush of USA in 1990 provided the basis for negotiations leading to the establishment of preferential trade agreements with Chile, Venezuela, Mercosur and the Central American Common Market(CACM). See Baldwin (1997); Bergsten (1996b); Bhagwati(1992a, 1992b, 1993), and WTO (1995) for deatils.

[22] Bergsten (1996b: 6) claims: "The United States reversed its traditional aversion to regionalism by embracing free trade agreements with Israel and Canada after the European Community blocked the launch of new negotiations in the GATT" [in 1982].

(b) On the other hand, many other analysts see RIAs as stepping stones (ie. building blocks) on the way to multilateral liberalization, because they tend to expand liberalization even though to a restricted group of countries (eg. Bergsten, 1996b; Dornbusch, 1990; Summers, 1992).

There are several empirical issues also raised in the context of this debate. These include:

(a) Has international trade become more regionalized?
(b) How durable is the current phase of regionalism?
(c) Does regionalization lead to slower growth of world trade?

On the first question, there seems to be no conclusive evidence for a strong trend suggesting greater regionalization of world trade (Carlisle, 1996; Lloyd, 1993; WTO, 1995).[23] The debate on the second issue - the durability of the current wave of regionalism - is motivated by the different conclusions that may emerge for multilateralism if this does become a long-term phenomenon. Bhagwati (1993) believes that conditions are in place for present wave of regionalism to endure, unlike the first wave of regionalism.

The third issue relates to whether regionalisation leads to a contraction of world trade (or slower growth). No strong recent evidence exists to support or reject either possibility. But the historical experience of international trade between 1850-1965 suggests that international trade slows down when global power becomes concentrated within a small number of countries, and several competing trade blocs are fonned.[24] RIAs, at present, will have only a minor effect, because a high proportion of trade is with outsiders, preferences have limited coverage and, in any case, non-members face rather low trade barriers.

[23] According to WTO (1995) intra-regional trade in 1993 was only 50.4 percent. However, Bergsten (1996) indicates that 61 percent of world trade in 1994 had been within RIAs.

[24] Edward Mansfield [quoted in Bhagawati (1993)]

1.6 New Trends in Economic Integration

1.6.1 Agglomeration

The revival of academic interest in the spatial dimension of economics[25] in the early 1990s has brought about renewed attention to the relationship between geography, trade and integration[26] following Krugman (1991), giving rise to the 'New Economic Geography'. While the rigid distinction between international and regional economics is no longer valid in a world where boundaries of nation-states can be quite different from those of economic regions, there continues to be an important difference between regional economics and international economics: whereas regional economics focuses on the joint effects of geographically mobile goods and factors, most of trade theory studies the effects of integrated product markets across spatially separated factor markets (Brulhart, 1998). If there are powerful underlying economic incentives for regional agglomeration that are hindered by existing trade barriers among nation-states, then RIAs that reduce such barriers may generate welfare gains.

Why and where do industries concentrate geographically? Marshall (1920) provided three reasons for location of industries in certain areas. In modern terms they are labour market pooling, supply of non-traded intermediate goods, and technological spill-overs. In new economic geography models, location becomes endogenous where production factors and/or firms are mobile. The literature on geography and trade focuses on how industrial agglomeration and regional differentiation can arise endogenously as a consequence of transport costs, market size and the trade policy regime (Krugman, 1991; Krugman, and Venables, 1995).

Location of Industry is dependent on the balance between production costs and trade costs[27] that must be incurred in supplying different markets. With increasing returns to scale in production that is internal to the firm, average cost falls as production expands. In general, production costs become lower

[25] Terms like economic geography, spatial economics and economics of location generally refers to the same concept. For the details of the early location theory see Baldwin and Venables.(1995)

[26] RIA's impact on a region's economic geography has long been neglected by economics (Baldwin, 1994).

as the volume of production increases, whereas trade costs increase, as consumers are dispersed.

In order to reduce trade costs, firms want to be located close to the largest market. Industry is its own customer for many products. Customers are located where the jobs are. Jobs are concentrated in places where the firms are located. Location of firms has a circular rationale. Firms want to be located closer to customers of the intermediate and final products and customers wants to be located where they can find jobs. This agglomeration of firms and workers' purchasing power in a particular place induces more firms to be located there. Decisions about the location of firms are influenced by the size of the market and the avoidance (or reduction) of trade costs. That location becomes the center.

The framework of analysis used by Krugman and Venables has important implications for regional economic integration. The link between location of industry and policy-induced trade barriers (a part of international trade costs) can be understood in this same framework. Consider two countries, one small and the other large. They are separated by prohibitive trade barriers. When trade costs are prohibitive, firms are forced to produce in each country. Producers of the small country face a small domestic market. With fixed costs and a small market, the price of the final product is higher than in the larger market. Producers in the larger market can offer lower prices if the trade barriers are lowered (say based on RIA). Then the price tends to come down in the small market]. It drives some of the firms producing in the small country to relocate in the large country (agglomeration) and export to the small country, and even to ROW.

In many new trade models, arguments are provided to show that liberalization between economies of different sizes may draw industries away from small countries into larger countries. In contrast, also based on a 'new trade' model, Puga and Venables (1998) demonstrated that a RIA between developed and developing countries could benefit both.

Developing countries will have improved access to a large developed country market and improved supply of intermediate goods. Benefits from these two sources are offset by the increased import competition from developed countries (because they get better access to the developing country market). Further, they have shown that a developed – developing countries RIA is superior to an RIA between two developing countries.

Centripetal forces drive industries to developing countries, and such forces are intensified by forward and backward linkages. Further, large countries will attract industries when trade barriers are intermediate or of low severity, though differences in factor prices can overturn these effects.

1.6.2 'Open' Regionalism

The defining characteristic of a 'closed' or traditional RIA is discrimination against non-members and preferential treatment for members. In 'open' regionalism, also known as 'non-discriminatory' regionalism, 'openness' has to be defined, and there are different definitions associated with the concept of open regionalism.

The main characteristics of open regionalism (OR) are that members"
(i) do not seek to disadvantage outsiders;
(ii) have transparent 'rules' including transparent criteria for admitting new members; and
(iii) actively promote wider membership" (Elek and Soesastro, 1997).

Not all open-RIAs conform to all of these aspects, but at least the first is common to in all such arrangements, and that is the defining characteristic of OR. The discriminatory (ie. closed) RIA receives international legitimacy if it conforms with the GATT (now WTO) agreement. The conceptualization and practice of or do not require such GATT/WTO legitimization, but it provides support to the GATT/WTO to strengthen the international trading system based on the Most Favored Nation (MFN) principle and the pattern of economic integration not restricted to a particular RIA. Hence it is designed not to reduce the existing levels of economic integration between countries after the formation of an open regional group irrespective of its membership.

The Asia Pacific Economic Cooperation (APEC) an open regional integration arrangement, aims to reduce impediments to international economic transactions, and is not designed to divert economic activities away from the rest of the world. Benefits from reduction in impediments to economic transactions (removal of negative elements to integration) are not confined only to the members, but are extended to non-members as well. Note however, that the APEC precludes any input into the decision making process by non members. Hence, not all the benefits of the

creation of 'public goods' within the group (positive elements of integration) can be availed of by non-members.

1.7 Concluding Remarks

The meaning of the term economic integration varies between various branches of economics. In the context of international economic relationships, it means the state of affairs as well as the process subscribing to economic links between two or more countries generally in the market framework. This term had not been used in economics in quite in this context before the 1940s. Even at present, the are a several terms used to refer to the same phenomenon: fusion, cooperation, openness, interdependence etc. In the context of economic efficiency economic integration is found in the area of the second best policy. The term economic integration is used to refer to either partial or general integration. A precise definition of economic integration has not been found even at present as various theorists continue to provide different views on the meaning of integration. It however deals with the process of removal of barriers to international movements of goods, factors and technology and also deals with the consequences of such movements.

Hence economic integration is concerned with the economic effects of integration in its various forms and with problems that arise from divergences in national monetary, fiscal and other policies. It is also concerned with the manner in which integration comes about. ie. Whether it results from unilateral reduction or removal of barriers to trade or whether it comes through the process of multilateral negotiations possibly under multilateral agencies like the World Trade Organization (WTO) [formerly the General Agreement on Tariff and Trade (GATT)] or whether it come through what might be called 'managed free trade' within a small group of nations.

Regional economic integration is both a state and process of economic links between two or more countries and within only a subset of countries in the world, generally close to each other, measured in a geographical context. In general a common economic space is created within such groups, benefits of which are designed to be exclusive for members. There are many stages of integration classified from FTA to TEI for analytical purposes. Integration arrangements in the real world do not conform to these patterns. The scheme

itself has been evolved based on the experience of the European Union. The new development like open regionalism is designed not to disadvantage non-members while it strengthens economic integration between the members. Liberalization of economic policy between economies of different sizes may draw industries away from small countries into larger ones as is predicted in new trade models. This creates a bias in favor of larger countries in the pattern of integration.

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