Economic Integration and Development

Has Regionalism Delivered for Developing Countries?

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This book is dedicated to our wives, Elisabetta and Marleen

Acknowledgements

Contents

1. Introduction and summary

Has regionalism delivered for developing countries? In one word, the answer is a qualified 'no'. This conclusion, however, requires a book-long explanation.

In the last two decades, concern has intensified in the developing world over the possibility of trade and investment diversion caused by regional groupings among industrial countries. This was due not only to the potential closing of existing markets in the short run (especially in view of the outward-oriented development strategy that many of these countries began to adopt over this period), but also to the potentially damaging policy precedent that it would set. In turn, there has been an enhanced tendency towards regionalism in both Europe and North America, where regional groupings embraced only industrial or industrial-and-developing countries.

Examples are the widening of the European Union (EU) towards Eastern Europe and its deepening through the Single Market Programme (EC-92) and the European monetary union; the creation of the Canada–USA Free-Trade Area (CUSTA) and the North American Free-Trade Agreement (NAFTA), which for the first time brought together a major developing country and developed countries. In fact, Japan and Korea are the only major countries that have not joined in any regional grouping, and even they are contemplating regional alliances.[1] This trend has intensified partly because of the fragility of the World Trade Organization (WTO), where the 1999 Seattle ministerial meeting failed to launch the anticipated Millennium Round. In large measure, this failure was due to the US insistence on labour and environmental standards which developing countries, in particular Brazil and India, felt would deprive them of their comparative advantage (as well as infringe on their national sovereignty).

As a counterpart to regional groupings in the developed world, there exist customs unions and free-trade areas among the developing countries. Prominent among them are the Common Market of the Southern Cone, or MERCOSUR – a customs union embracing Brazil, Argentine, Uruguay and Paraguay – and the ASEAN Free-Trade Area (AFTA), a free-trade area encompassing ten Southeast Asian countries. AFTA was originally composed of six countries (the resource-rich 'ASEAN-4' – Indonesia, Malaysia, the Philippines, and Thailand – Singapore, and Brunei Darussalam); and lately expanded to include Vietnam, Laos, Myanmar (formally Burma) and Cambodia. There are also regional groupings in Africa, the Middle East, and other parts of Latin America.

However, these groupings are too small to be considered serious counterweights to the EU and NAFTA. Moreover, their trade and investment orientation is directed towards outside their respective regions.

For these reasons, there is no concern in industrial countries about the impact of regional groupings in the developing world. But the reverse is not true. There is intense concern in the developing countries regarding trade and investment diversion in Europe and North America. During 1997–9, this concern has been exacerbated by the financial crisis originating in Southeast Asia and spreading elsewhere. The idea that the internal growth effects of the EU and NAFTA will promote imports from the developing countries and offset the diversionary effects is also being widely questioned.

This is the topic that this book addresses. After chapters surveying the theory (Chapter 2) and empirics (Chapter 3) of regional integration, there are two chapters dealing with the questions mentioned in the previous paragraph: the effect of industrial groupings on the developing-country exports (Chapter 4); and the impact of industrial-country groupings on direct foreign investment patterns (Chapter 5). Chapter 6 focuses on economic cooperation in ASEAN, including the question of whether or not an ASEAN currency area is in the making. Chapter 7 attempts to capture any 'anticipatory effects' that the ASEAN free-trade area might have generated (we find little evidence of any). Finally, Chapter 8 considers economic integration in the Americas, with a focus on MERCOSUR. It also offers statistical comparisons with ASEAN.

Chapters 4 and 5 contain the core of the empirical research, employing a variety of statistical approaches to assess the aforementioned effects. While studies undertaken in the 1990s examine these questions *ex ante*, our focus is on what has actually happened, that is, *ex post* analysis.

We found significant trade diversion in specific manufacturing categories, in particular, electronics. These are commodities that constitute an increasing share of Asian exports. The negative effect of the Single Market Act appears to be stronger than that of NAFTA. With respect to direct foreign investment, while no definite conclusion is reached, we could not discern any diversionary effect to justify the concern of developing countries.

It is because of the trade impact that we offer a qualified 'no' to the question raised in the title of this book. Developing countries have an abiding interest in minimizing discrimination against them, and that can be accomplished only in the context of WTO negotiating rounds. Hence it is not only the industrial countries that have an interest in a Millennium Round concentrating on services, agriculture and investment questions. Rather, developing countries have at least an equal, if not a deeper, interest in participating actively in negotiations on liberalizing commodity trade. The Seattle débâcle was a failure not only from the point of view of the United States – though it is often portrayed as such in the press – but also from the point of view of the developing world.

In past years, economists have urged developing countries to participate actively in GATT/WTO negotiations, rather than rely on 'free' concessions exchanged between the industrial countries, because that is the only way they could achieve trade liberalization in products of export interest to them. Now we add another reason to highlight their stakes in global negotiations: to minimize the discriminatory impact of regional groupings, especially in Europe and North America. If the proposed 'Free Trade of the Americas' is implemented, discrimination against Asia will intensify.

Why was the answer given in the first sentence a *qualified* 'no'? Because regional integration occurs not only among industrial countries but also among developing countries, and in some cases such integration may benefit them. For example, Chapters 6 to 8 survey the two major preferential trading arrangements in the developing world: MERCOSUR, a customs union, and AFTA, a free-trade area. Here evidence of the effects on trade and investment flows are scanty, because not many studies have been devoted to the topic, and too few years have elapsed since the inauguration of these regional arrangements. Such as it is, there is *ex ante* evidence to suggest trade creation by AFTA, although that was not borne out by preliminary *ex post* analysis. Likewise, MERCOSUR was probably responsible for changes in trade flows, but in certain areas (such as motor cars) these changes appear to have been due to trade diversion. This is because the common external tariff in these sectors was high, and increased recently.

In this sense, the ASEAN and MERCOSUR experiences are quite different. Most ASEAN countries began a comprehensive liberalization of their trade regimes in the mid to late 1980s, and AFTA was superimposed upon a liberalized trade regime. In other words, AFTA was a regional expression of an export-oriented development strategy that had been adopted by its member countries. By contrast, in certain sectors, the MERSOSUR customs union was superimposed upon an import-substitution strategy and, therefore, intensified discrimination against outsiders. In these areas, trade diversion could easily swamp any trade-creating benefits of liberalization. Indeed, this may be the result in other regional groupings in the developing world, such as SAARC[2] and ECO,[3] which are beginning economic integration programmes in the context of inward-looking regimes.

In conclusion, regional integration between developing countries is welfare-enhancing only if it is outward-looking and minimizes discrimination against outsiders.

This book leads to three important policy conclusions. First, in designing preferential trading arrangements, developed countries should recognize and attempt to minimize the possible discriminating effect on developing countries; second, the developing countries have an abiding interest in the success of WTO negotiations that would minimize the discrimination against them of

regional groupings in Europe and North America; and third, any customs unions or free-trade areas among the developing countries themselves should be outward-looking if they are to enhance the welfare of developing countries.

NOTES

1. Japan and Korea are both members of the Asia–Pacific Economic Cooperation organization (APEC), and it is not clear yet whether the 'Bogor Vision' of open trade and investment in APEC by 2010 (2020 for developing countries) will be non-discriminatory; and (2) Japan and Korea are currently exploring the feasibility of a bilateral free-trade area.
2. The South Asian Association of Regional Cooperation (SAARC) is composed of India, Pakistan, Bangladesh, Nepal, the Maldives, Sri Lanka, and Bhutan.
3. The Economic Cooperation Organization is composed of Turkey, Pakistan, the Islamic Republic of Iran, Azerbaijan, Afghanistan and the Central Asian republics.

2. The theory of preferential trading arrangements: an overview

INTRODUCTION

It is a standard result of international trade theory that free trade maximizes global efficiency in a distortion-free world. All Pareto-efficient conditions are met; free trade is the 'first-best' solution. However, a world ridden by multiple distortions (such as, tariffs, quotas and exchange controls) does not necessarily move closer to Pareto optimality by the removal of one distortion. Some Pareto-efficient conditions will be satisfied, but others may be disturbed because of the change. The net result could be either a gain or a loss relative to the status quo; *a priori* we cannot determine which. This is the fundamental result of the 'general theory of second best'.

The formation of a free-trade area involves such a trade-off of distortions. It eliminates tariffs between member states and, therefore, establishes an undistorted price relationship between the home and partner countries. But there is a perversion in price relationships between partner and non-partner countries, as the latter are discriminated against. The net welfare effect is ambiguous, and cannot be determined *a priori*.

It is, therefore, necessary to investigate the conditions under which a free-trade area (FTA) or a customs union (CU)[1] represent a movement toward the Pareto optimum, that is, free trade. This chapter reviews theoretical models that attempt to answer this question. For consistency with the literature, we refer here mostly to CUs, but the effects of an FTA are similar. The next section begins by outlining the logic of the pre-Vinerian analysis of the effects of CUs, followed by a presentation of Viner's critique of that analysis. The third section reviews extensions and critiques of the Vinerian model, and the fourth section presents several approaches to evaluating the welfare effects of CUs. The review involves both partial and general equilibrium paradigms. Finally, a summary is given at the end of the chapter.

Unless otherwise specified, we assume throughout the chapter that (1) markets are competitive, (2) there is full employment of economic resources at all times, (3) international trade in commodities and services must balance, (4)

capital transfers are non-existent, (5) tariff revenues are redistributed to consumers, and (6) there are no externalities in production or consumption.

VINER AND THE 'ORAL TRADITION'

Prior to Jacob Viner's classic work, *The Customs Union Issue* (1950), the treatment of CUs was devoid of an explicit economic framework. The consensus was that, because CUs constitute a partial movement toward a free-trade world, their creation implied an improvement in economic welfare. Viner was the first to demonstrate the shortcomings of this reasoning. He argued that, if a CU were to improve economic welfare, then it must be the case that post-union commodity purchases are supplied from lower cost sources than in the pre-union period. He distinguished two effects of a CU. A favourable 'trade creation' effect occurs when previously protected inefficient production in a country is displaced by imports from a partner country, when the tariff between them is removed as a result of the CU; an unfavourable 'trade diversion' effect occurs when the most efficient imports from a non-member country are replaced by less efficiently produced imports from a partner country because of the discrimination against outsiders. The CU represents a movement towards free trade only if trade creation exceeds trade diversion. By introducing the distinction between trade creation and trade diversion, Viner established the foundation upon which the 'general theory of second best' would be built.

## EXTENSIONS AND CRITIQUES OF VINER

James Meade (1955) extended Viner's results. He maintained that in order to assess the changes in welfare caused by a CU it is necessary to evaluate the extent to which costs have been raised on each unit of diverted trade and lowered on newly created trade. Meade sought to establish a method by which the trade creation and trade diversion effects could be weighted in deriving a 'unique indicator of desirability' for CUs. An *ad valorem* tariff on a commodity drives a wedge between the price consumers pay and the amount producers receive, the difference being equal to the tariff. In a perfectly competitive world, the price of a good represents its marginal utility to consumers; conversely, marginal cost represents the marginal disutility to the producers. Assuming that the marginal utility of money is the same for buyers and sellers, then for each unit increase in expenditures on the good, there is a net gain to society equal to the excess of the utility to consumers over the disutility to producers. The net welfare gain is therefore equal to the size of the tariff.

Suppose that all imports are subject to the same *ad valorem* tariff. If there is a marginal reduction in the tariff rate for one good, there will be a readjustment in purchases of imports due to the change in relative prices. Since there is an equal welfare gain (loss) caused by any marginal increase (decrease) in expenditures on any good, the change in welfare to society is determined by the change in the volume of trade. If it increases (decreases), the tariff reduction will have increased (decreased) social welfare. Consequently, the net welfare effect of a CU can be determined by evaluating the change in the volume of international trade.

Another limitation of the Vinerian model is that it concentrates exclusively on production effects, that is, the inter-country substitution in production of traded goods. There is no analysis of inter-commodity substitution in consumption that follows from changes in prices resulting from CU formation. Combined with the assumption of a linear transformation curve, the fixed coefficient in consumption ensures that a trade-diverting CU (TDCU) will decrease economic welfare. However, if either of these assumptions is dropped, a TDCU may lead to welfare improvement. The rest of this section demonstrates this possibility.

Figure 2.1 shows graphically Viner's model. The home country, Spain, has a linear transformation curve (AD) between X and Y, the only two goods in this three-country paradigm. In addition, there is a fixed coefficient in consumption: X and Y are always consumed in the proportion defined by the ray OZ. Consumption in autarky is therefore at E. Once free trade is opened, Spain, assumed to be a small country, can trade at the terms of trade of the most efficient producer of the good in which it has a comparative disadvantage. Suppose that ROW offers terms of trade AB and the EC offers AC. Spain trades Y for X with the country offering the best terms of trade, which in this example is ROW. Consumption is at G, where Y_2A of Y is traded for OX_2 of X. More is consumed of both X and Y at G than at E; hence, Spain is unambiguously better off under free trade.

If Spain were to levy a non-discriminatory *ad valorem* tariff on both the EC and ROW, the analysis would not be affected. Spain would continue to import from ROW at the same terms of trade, which Spain (a small country) cannot alter. When Spain and the EC form a CU, then, if the common external tariff of the CU is prohibitive to ROW, the EC will export X to Spain in exchange for Y. Trade is diverted from ROW. The terms of trade that Spain faces will be AC, and consumption will be at F. Consequently, Y_1A is exported in exchange for OX_1, which leaves Spain at an inferior position compared to G. More is exported in exchange for fewer imports; thus a TDCU in the Vinerian model leaves the home country worse off.
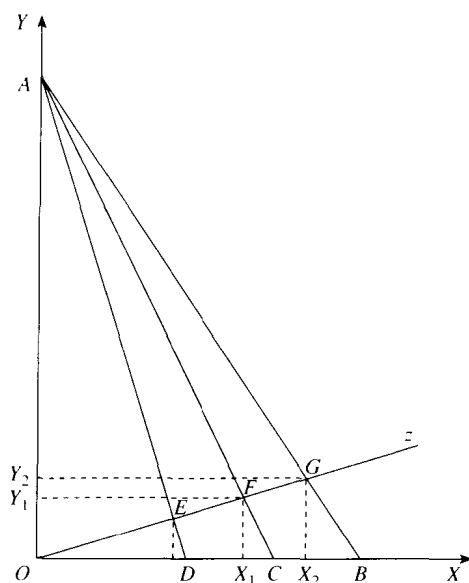
Figure 2.1   Trade-diverting customs unions in the Vinerian model

But, following Gehrels (1956–7), we now relax the assumption of a fixed coefficient in consumption. Using indifference curves, he shows that the welfare-enhancing attainment of a tangency solution between the domestic marginal rate of commodity substitution (MRS) and the marginal rate of transformation (MRT) in production in the post-union phase can offset the welfare inhibiting effects of trade diversion in production. This could render the TDCU beneficial to the home country.

This argument is shown in Figure 2.2. The tangency of indifference curve I_1 and AB at point D represents the highest achievable utility for Spain under free trade; it is the first-best solution. But suppose that Spain levies an *ad valorem* non-discriminatory tariff on good X. Trade is still carried out with ROW, but the terms of trade facing consumers are now SP. Consumption takes place at T, with I_1 lying above the terms of trade line facing Spain. Relative to the Pareto optimum, too much Y is being consumed because of this price distortion; I_{11} is inferior to I_1.

Line AM represents the terms of trade which would leave Spain exactly as well off as under tariff-ridden trade with ROW. That is, at relative prices AM,

Spain consumes at E (where MRS equals MRT), which is the same utility level as at T. Hence, if the EC offers terms of trade that are at least as attractive to Spain as AM (that is, terms of trade at which the relative price of X is lower), a higher indifference curve can be reached. Trade is diverted, but Spain's welfare increases.
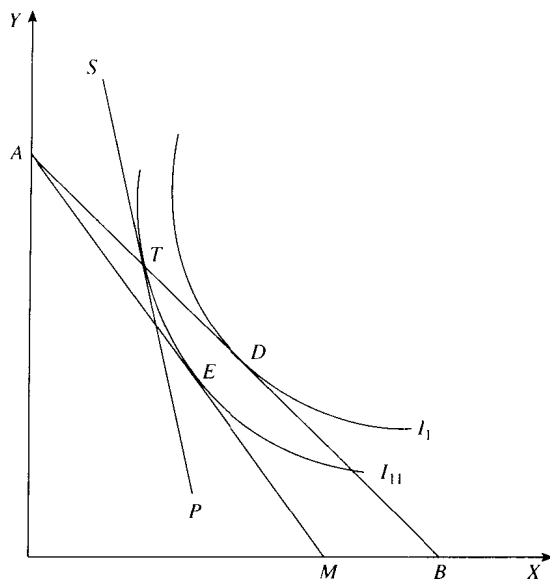
Source: F. Gehrels, 'Customs Unions from a Single-Country Viewpoint', *Review of Economic Studies*, 24 (1956–7).

Figure 2.2   Effects of a customs union with inter-commodity substitution

With the possibility of commodity substitution in consumption, there thus exists the possibility of a welfare-enhancing TDCU. In fact, Gehrels reasoned that a CU would bring gains rather than losses. Lipsey (1960), however, points out the two-goods assumption implicit in Gehrels' analysis. We noted in the introduction that a CU will impose negative effects on efficiency because it distorts the price relationships between partner and non-partner prices. If there are only two goods in the model and a linear transformation curve, Spain will import X from either the EC or ROW. This partner/non-partner price distortion does not exist by assumption. But if there are more than two goods and some goods are imported from both ROW and the EC, the problem of partner/non-partner price distortions appears.

To see this, refer to Table 2.1, which assumes a three-good/three-country world. The Spanish domestic commodity is *A*; the imports from the EC and ROW are *B* and *C*, respectively. Subscripts *d* and *i* refer to prices in the domestic Spanish market and the international market, respectively. Under free trade (column 1), all three Pareto optimal conditions are met. If Spain imposes a non-discriminatory tariff on both *B* and *C* (column 2), the Spain/EC and Spain/ROW price relationships are disturbed, but the EC/ROW price relationship is held intact. When a CU is formed between Spain and the EC (column 3), an undistorted relationship between Spanish and EC prices is established, but at the expense of disturbing the EC/ROW price relationship. Thus, while Gehrels' conclusion would have brought us back to the pre-Vinerian notion that CUs always increase welfare,[2] Lipsey shows that this is not the case; welfare could either increase or decrease.

Table 2.1   Spanish domestic and international price relationships under alternative trade policies

Free trade	Non-discriminatory ad valorum tariff on all imports	Customs union with the EC
$\dfrac{P_{Ad}}{P_{Bd}} = \dfrac{P_{Ai}}{P_{Bi}}$	$\dfrac{P_{Ad}}{P_{Bd}} < \dfrac{P_{Ai}}{P_{Bi}}$	$\dfrac{P_{Ad}}{P_{Bd}} = \dfrac{P_{Ai}}{P_{Bi}}$
$\dfrac{P_{Ad}}{P_{Cd}} = \dfrac{P_{Ai}}{P_{Ci}}$	$\dfrac{P_{Ad}}{P_{Cd}} < \dfrac{P_{Ai}}{P_{Ci}}$	$\dfrac{P_{Ad}}{P_{Cd}} < \dfrac{P_{Ai}}{P_{Ci}}$
$\dfrac{P_{Bd}}{P_{Cd}} = \dfrac{P_{Bi}}{P_{Ci}}$	$\dfrac{P_{Bd}}{P_{Cd}} = \dfrac{P_{Bi}}{P_{Ci}}$	$\dfrac{P_{Bd}}{P_{Cd}} < \dfrac{P_{Bi}}{P_{Ci}}$

Note: d = domestic market; i = international market.

Source: R. Lipsey, 'The Theory of Customs Union: A General Survey', *Economic Journal* (1960); reproduced in J. Bhagwati (ed.), *International Trade: Selected Readings* (Cambridge, MA: MIT Press, 1982), p. 269.

Moreover, if the Vinerian assumption of a linear production possibility frontier is replaced by a concave transformation curve, thereby allowing for incomplete specialization in production, the likelihood of a welfare-enhancing TDCU also increases. This is demonstrated in Figure 2.3(a), which depicts Spain's domestic economy, characterized by production possibilites frontier PQ. In the two-good/three-country model, the line ROW represents Spain's