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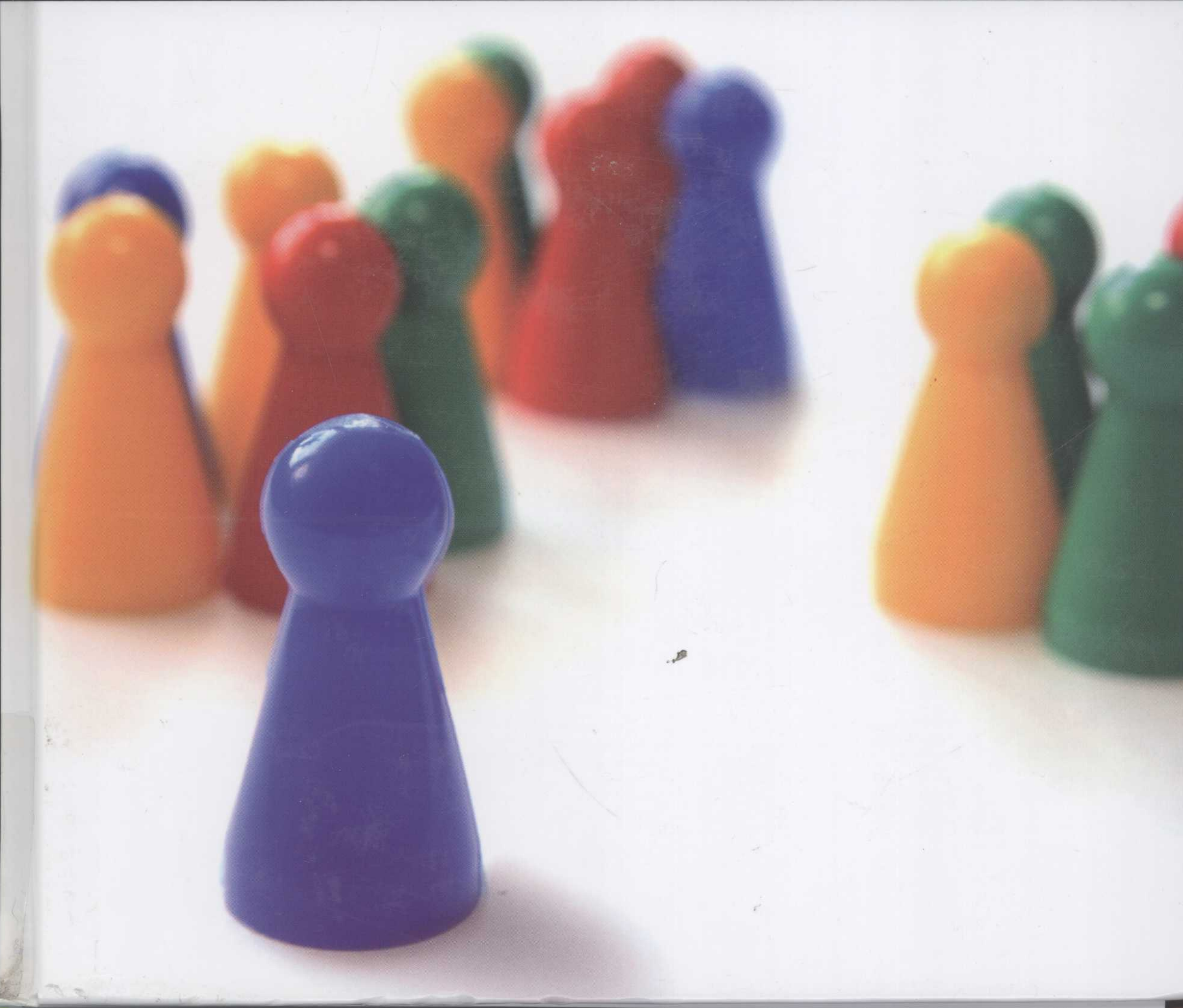
International Handbook on the Economics of Integration, Volume II

Competition, Spatial Location of Economic Activity and Financial Issues

Edited by **Miroslav N. Jovanović**



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Similarly, if anyone competes as an athlete,
he does not receive the victor's crown
unless he competes according to the rules.
2 Timothy 2:5

Својим синовима Јовану и Николи

Στους υιούς μου, Γιάννη και Νικόλαο

Ai miei figli, Jovan e Nikola

To my sons, Jovan and Nikola

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Foreword

Economic integration at the international level used to be a European specificity; this explains why a European Institute has a major interest in supporting a handbook on international economic integration. Alongside the development of theories about international economic integration initiated in the 1950s, the European Economic Community, launched in 1957 among six (Western) European states, very soon appeared as the practical exercise designed for implementing such theoretical concepts. Thus economic integration is a strong element at the heart of European studies.

The Geneva University European Institute aims at understanding the great transformation of Europe, and not only the development of the European Community (EC) or the European Union (EU), while acknowledging the pre-eminence of the integration process driven by the EU in this evolution. European integration, even though initially based on the promotion of economic integration, also covers a much wider scope of human activities, spilling over into legal, political and even societal issues. This is why, since 1963, European studies at the University of Geneva have been pooled in an interdisciplinary institute; economic integration – even though a fundamental and necessary parameter of wider integration – is thus, and remains, closely interlinked with other societal factors. Interdisciplinary studies, however, in no way prevent comprehensive disciplinary efforts, such as the present Handbook.

International economic integration, for its part, changed gear in the late twentieth century, after the failure of the socialist model. In Europe naturally, where socialist countries of the Central and Eastern part of the Continent have been called to join the European integration process (EU), but also beyond Europe. This geographical spreading of international economic integration actually took two forms, both consequences of the undisputed dominance of the liberal model. The first one is globalisation, a phenomenon – whose anatomy is studied below by the editor of the Handbook – largely accelerated by both the development of new technologies and the conclusion of the Marrakesh Agreements of 1994, which closed the Uruguay Round and created the World Trade Organization (WTO). The second form consists in the realisation of numerous cases of regional economic integration, the latest example being the coming into force on 1 January 2010 of the free trade area between China and ASEAN; it follows the realisations of MERCOSUR, NAFTA, ECOWAS and other regional regimes. Both processes involve international economic integration, even though sometimes in contradictory terms – as is shown by the tensions existing between Articles I and XXIV (5) of the GATT Agreement (see the contribution by Lipsey and Smith on that issue, Vol. I, ch. 3). Thus the issue of international economic integration has to be conceptualised anew and analysed with regard to all these recent developments.

Since 2008, the European Institute of the University of Geneva has had the privilege of counting among its lecturers Dr Miroslav Jovanović, editor of this three-volume Handbook. His enthusiasm for teaching and the wide network of contacts he entertains throughout Europe and the world allowed this ambitious project to turn into the book you are holding. Not only a learned scholar, Dr Jovanović also holds a position at the

UN Economic Commission for Europe (UNECE), a UN subsidiary body dealing with economic issues within Europe as a whole. Thus my colleague has both an extraordinary observation position – at the heart of the most advanced regional economic integration process going on in Europe – and the proper distance for academic observation, since UNECE is not directly part of the mainstream process of the economic integration taking place within the EU, and Switzerland is not a member state of the EU.

Thus, Geneva is a highly interesting place for undertaking the work of editing such a handbook. Not only because it is the seat of the WTO, a focus point for trade liberalisation regimes, but also because it is the seat of numerous other international organisations (ILO, WHO, WMO and ITU, among others), all closely linked to the ongoing global economic integration, which reaches far beyond international trade. Thus an 'economic-plus' integration process may, perhaps, be at work – in a form yet to be determined – at the world level, perhaps based on lessons learned from the most successful regional economic integration processes. Too soon to tell, of course; but if it has to be observed, it could well be in Geneva, by Dr Jovanović and the 'dream team' of economists he has gathered together to contribute to this Handbook. The European Institute at the University of Geneva is therefore proud and happy to be associated with this project. All my thanks to my colleague Jovanović for the contribution he thus brings, both to the understanding of the international economic integration process and to the academic renown of the European Institute of the University of Geneva.

Nicolas Levrat
Director of the European Institute
of the University of Geneva

Introductory note

Regional economic integration has the potential to complement national development strategies and to address some of the longstanding structural weaknesses of many developing and least-developed countries. UNCTAD research shows that integration – when implemented within a broader development strategy that promotes economic and trade diversification, structural changes and technological development – may enhance productive capacities, realise economies of scale, help to promote technology transfer, create new markets and improve competitiveness. Through the development of regional trade integration, firms can boost their competitiveness and diversify export markets. Regional economic integration can, therefore, be a launch pad for the effective participation of developing countries in the global economy.[1]

These days, regionalism has forcefully returned to the forefront of attention. One reason for this has been the slow progress in the Doha Round of multilateral trade negotiations that has led countries to increasingly pursue regional agendas. However, the benefits of regional integration cut deeper than this – as is clear by the evidence linking regional integration with economic growth and poverty reduction. One thinks in particular of the experience of economic and political integration in Europe; and of the differences in economic performances of the Asian region, where regional trade accounts for a very high proportion of total trade and economic growth has been rapid, compared to some countries in Africa, where regional trade accounts for less than 10 per cent and growth has been slow or even stagnant.

Trade is essential for regional integration and cooperation to support the development policy agenda, and it has to extend beyond trade liberalisation. It needs to include policy areas that strengthen the potential for growth and structural change in developing countries. These include macroeconomic and financial management, as well as trade support and industrial policies.

There is a considerable body of economics literature, mostly in the branch of international trade theory, which views regionalisation with alarm and sees it as the result of trade-diverting agreements which threaten to undermine the global trading system. Such agreements may have played some role in boosting regional trade at the expense of multilateral transactions, but it is far from clear that this is inevitably the case; indeed, there are a number of more fundamental forces at play that tend to be ignored by mainstream trade theory. Regional trade in Europe, North America and, increasingly, in East Asia is largely dominated by intra-industry exchanges of intermediate manufactures and capital goods, and these reflect a very high degree of specialisation in the various stages of the manufacturing production process. Intra-industry trade has the propensity to be most intense among industrialised (or industrialising) countries at similar levels of

[1] UNCTAD (2009), *Economic Development in Africa Report*, United Nations, New York and Geneva; UNCTAD (2007), *Trade and Development Report 2007: Regional Cooperation for Development*, United Nations, New York and Geneva.

development and is driven by dynamic economies of scale and specialisation and by the search for long production runs. These processes tend to generate economies of agglomeration and to trigger cumulative patterns that reinforce the degree of concentration over time.

Once such processes are under way there will be pressure from producers within the region to lower or remove the various barriers to intra-regional trade, including bureaucratic red tape, conflicting legal restrictions and administrative procedures and so on, as well as demands for better transport and communications infrastructure. These various demands are likely to be accompanied by the creation of institutions for closer regional cooperation, as has happened, for example, in Western Europe. At first, such cooperation will tend to focus on technical issues (trade barriers, standards and the like) but as regional production systems become ever more integrated, so the regional policy framework is likely to expand.

With these underlying processes in mind, it seems clear that regional economic integration can contribute to generating development prospects in a wide range of areas. It can improve development prospects in terms of physical infrastructure, which is often missing or of poor quality in developing countries. Road, rail or air transport are areas where cooperation on major investment projects can help reduce bottlenecks in public infrastructure. Energy and water supply are other cases in point. The first Union of South American Nations (UNASUR) Summit on Energy held in 2007 was a successful experience, promoting energy integration in the region.

In the context of regulatory and institutional cooperation, regionalism can also help address those areas which present today's central development challenges. Cooperation in the regulation of infrastructure services sectors can facilitate the supply of energy or water to the poor and marginalised by creating economies of scale that contribute to extending the coverage of services at lower costs.

Cooperative regional arrangements on monetary and financial aspects, such as the Chiang Mai initiative, provide valuable tools for the stabilisation of intra-regional exchange rates, and thereby reduce their potential to serve as a source of instability or as a transmission mechanism for global shocks. The Bank of the South (Banco del Sur), recently established by seven South American countries to finance development projects in agriculture, energy and health care for member nations and to enhance trade, is yet another example. Cooperation in areas related to migration and the movement of people, the protection of the environment or the management of river basins provide further evidence. Other areas in which regional integration may also bring substantial improvements are education, research and development, and transfer of technology.

South–South cooperation has also been deepened on agriculture, rural development and food security, for instance: the Comprehensive Africa Agriculture Development Programme (CAADP);[2] the New Partnership for Africa's Development (NEPAD), the Council of Agriculture of South America (CAS); and the ASEAN Integrated Food Security (AIFS) Framework and the Strategic Plan of Action on ASEAN Food Security (SPA-FS) adopted by the 14th ASEAN Summit in 2009.

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[2] UNCTAD, 'The role of South–South and triangular cooperation for sustainable agriculture development and food security in developing countries', TD/B/C.II/MEM.2/5, 2009.

In UNCTAD we have a particular interest in regional integration on trade, an area which has been highly dynamic over the last decades. Since the 1990s there has been a proliferation of regional and bilateral free trade agreements (FTAs) or preferential trade agreements (PTAs) between developed and developing countries. The number of currently operational regional trade agreements (RTAs) notified to the World Trade Organization (WTO) has risen from less than 100 in 1995 to more than 225 in 2009. Consequently, more than half of world merchandise trade, and a significant portion of trade in services, fall under regional trading regimes.[3] The scope of RTAs has evolved significantly over time. The newer generation of RTAs – characteristic of the so-called 'new regionalism' – has wider coverage, going beyond just tariff measures to include deeper 'behind-the-border' regulatory policy measures, such as services, investment, competition policy, government procurement and labour mobility, as well as such non-trade policy commitments as current and capital account opening. The financial and economic crisis has accentuated the vulnerability of countries that have made broad and deep commitments through RTAs.[4]

There are numerous reasons for developing countries to negotiate RTAs: to secure market access, to obtain preferential concessions or to overcome stalemate in the Doha Work Programme. Nevertheless, RTAs, particularly when undertaken on a North–South basis, also present multiple – sometimes difficult – choices for developing countries. RTAs may require sharp tariff reductions (which can expose domestic manufacturers to overwhelming competition), include the WTO 'plus issues' (for example, competition, investment or government procurement), replace special and differential treatment with full reciprocity or even lead to preference erosion.[5]

Hence, in assessing the possible economic and social benefits and costs of entering into North–South bilateral or regional FTAs, developing countries should not only look at the potential changes in exports and imports arising from new or more secure market opening but also consider the impact of such agreements on their policy options and instruments for longer-term development.

In the years from 1995 to 2007, trade growth in developing countries doubled its ratio to GDP, reaching more than 50 per cent of developing-country domestic output – illustrating the importance of trade as a channel of finance for development. In particular, South–South trade between developing countries increased by more than three times its 1995 level, reaching almost 46 per cent of their total trade in 2007. These trends helped developing countries to diversify production and create new trade and investment flows.

Linking South–South trade to structural transformation will pose different policy challenges for different groups of countries. For African economies, South–South trade offers opportunities for diversification away from commodity dependence, and perhaps

[3] Roberto Fiorentino's chapter in this Handbook (Volume I, ch. 1), entitled 'The never-ending story of regional trade agreements', examines recent developments in RTA proliferation.

[4] UNCTAD, 'South–South cooperation and regional integration: where we stand and future directions', TD/B/C.II/MEM.2/2, 2008.

[5] See the chapter by Richard G. Lipsey and Murray Smith in this Handbook (Volume I, ch. 3), entitled 'Multilateral versus regional trading arrangements: substitutes or complements?', for an examination of the political economy dynamics of RTAs.

more so than their trade with the North, although this is likely to vary across product groups. It also offers some middle-income economies in Asia and Latin America an opportunity to avoid producing only relatively unsophisticated manufactured goods. Moreover, new opportunities might be emerging for those developing countries, which export higher value-added, technology-intensive products.[6]

The recent financial and economic crisis has forced Northern economies to undertake large-scale adjustments (at the household, government and national levels) and to correct the massive financial imbalances that have built up over the last few years. This has slowed down consumption and growth in these economies, and it has also exposed the dangers of relying too heavily on Northern economies as main trading partners. These developments suggest that Southern trade, as both a vent for surplus and a source of diversification and upgrading, might take on an even greater importance over the coming years.

Expanding these opportunities will not come automatically, it will depend on renewed cooperation among countries of the South. In this respect, South–South trade should not be approached as a stand-alone engine of growth, but as part of a broader set of interdependent challenges involving investment, structural changes and technological upgrading.

The area of international investment has also seen important developments at the regional level. In the case of East Asia, a close association between the pattern of industrialisation and its regional location has been linked with the upgrading of economic activity from resource-based and labour-intensive industries to more and more sophisticated manufactures by the lead economies, which in turn has opened up opportunities for the less-developed neighbouring countries to enter the regional division of labour by engaging in less-demanding activities.

To stay ahead, the countries in the first tier of development have been forced to move up the trade hierarchy and export more sophisticated products where they now have a comparative advantage, with foreign direct investment (FDI) providing one possible route for recycling comparative advantage. This idea of a regional division of labour, combining an industrial and locational hierarchy, has been described as the 'flying-geese' development paradigm. Within this paradigm, government policy has been central to the regional impact of FDI, and when drawing wider lessons from this experience, it should not be forgotten that much of the international spillovers within East Asia have been ultimately generated because of the success of the industrial policy of the first-tier newly industrialised economies, rather than through a purely market-generated process.[7]

UNCTAD, which is the focal point within the United Nations Secretariat for matters related to FDI, is collecting – and disseminating – data on investment rule-making at the regional level. The number of BITs – bilateral investment treaties – has risen rapidly across the world. From 388 in 1990, the number at the end of 2008 reached a total of 2,676. Among developing countries, Asia led the conclusion of BITs, with 31 new BITs

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[6] UNCTAD, 'Making South–South trade an engine for inclusive growth', Policy Brief 8, November 2009.

[7] UNCTAD has provided an extensive discussion of the East Asian model of development in its Trade and Development Reports, in particular those in 1994, 1996 and 2003.

in that year alone. However, just how successful BITs are in attracting FDI remains an open question, and further research is needed on this issue, including on whether such treaties involving developing countries carry clear advantages. Besides BITs, international investment rules are progressively being adopted as part of regional, inter-regional and plurilateral trade agreements. These agreements have been multiplying steadily (287 by the end of 2009). Again, a large majority of agreements – about 87 per cent – have been concluded since the 1990s. Until the late 1980s, investment facilitation through these agreements remained confined mainly to intra-regional processes involving countries at similar levels of development, albeit with a few exceptions (such as the agreements between the European Community and developing countries). Since 1990, however, countries and groups located in different regions have concluded trade and investment agreements with one another, involving both developed and developing countries.

The spreading of these types of agreement has been one of the key developments in international economic relations in recent years. These 'other IIAs' are particularly relevant as they manifest a trend towards a more integrated approach when dealing with interrelated issues in international investment rule-making. Their greater variation presents an opportunity for experimenting with different approaches and accounting for the special circumstances of countries in different regions and at different levels of economic development. At the same time, their complexity increases and so does the likelihood of overlaps and inconsistencies between provisions. Over time, the negotiation of these agreements has created a multifaceted and multilayered system of overlapping – and sometimes also contradictory – rules.

All these and many more, are good reasons for the development community to take a careful look at the state and prospects of regional cooperation and economic integration today. In UNCTAD, we attach great importance to the close collaboration with academia, creating useful linkages between policy making and theory. Studies like this International Handbook are, therefore, a major achievement and I would like to thank all the participants for the hard work and congratulate everybody for the impressive contributions they are making to this welcome endeavour.

Petko Draganov
Deputy Secretary-General
UNCTAD

Preface

The importance of international economic integration is well recognised. It has touched most of the countries in the world and has become an unavoidable element in most national economic policy decisions. In fact, most countries have attempted to integrate with others, creating a global 'spaghetti bowl' of trade regimes and agreements. The biggest and deepest achievements in integration have been among the developed countries, in particular in Europe. Countries in other regions of the world have tried to copy, both formally and informally, certain integration accomplishments that took place in Europe, but with varying degrees of success.

Policy makers usually had a favourable view regarding integration. They attempted to use economic integration as a means for securing access to a wider market, to locate certain production (and employment) within the confines of their influence and to reinforce growth in order to achieve a higher level of national welfare. The global credit crunch (2007–08) and the related global economic recession were followed by a wave of 'economic nationalism' in the form of 'buy domestic' campaigns, in which many countries throughout the world introduced direct and indirect protectionist measures. This was compounded by a continuing stalemate in the Doha Round of multilateral trade negotiations under the auspices of the World Trade Organization. International economic integration and the multilateral trading system suffered a temporary setback. None the less, international economic integration remained an attractive longer-term economic strategy for most countries. In fact, in the longer term there may be several bigger integration groups in the world that will deal with one another.

The process of international economic integration has been characterised by several factors since the mid-1990s:

- A rapid increase in the number of integration deals among countries. This is compounded by continuous problems and a lack of progress in the Doha Round of multilateral trade liberalisation negotiations.
- A deepening and widening integration in the European Union (EU) and, to an extent, in North America and South-East Asia.
- Various forms of economic integration between developed countries in Europe with less-developed ones in Central and Eastern Europe; as well as between the United States and Canada with Mexico, a country that is still in the process of economic development; and similar North–South integration efforts in South-East Asia.
- A change in economic policies in the developing countries towards more outward-looking models.
- Progress in technology and changes in demand which create new opportunities and challenges for theorists, policy makers and business executives. As a number of economic activities became fragmented, 'footloose', highly mobile in space and internationally connected, one of the most demanding and intricate questions in such a situation is where would firms and industries locate, relocate or stay? Where does international economic integration take place in these circumstances?

- A transformation of contemporary economies from commodity manufacturing to knowledge-based economies.
- Last but not least, a massive international relocation of manufacturing towards China, in spite of integration efforts elsewhere.

The objective of this three-volume Handbook is to offer an insight and introduction into the principal contemporary economic issues linked with international economic integration. The literature on the various strands of the issue started in the 1950s in the works of Jacob Viner, Jan Tinbergen, James Meade, Helen Makover, George Morton, Tibor Scitovsky, Franz Gehrels, Richard G. Lipsey and Harry G. Johnson. It continued its evolution during the 1960s. Integration seemed to be an almost dead research issue during the 1970s and until the mid-1980s. Then, the EU's Single European Market Programme (1985–92) for the opening of the internal market in the Union prompted a flow of studies on various aspects of economic integration, mainly in Europe, but also elsewhere, which has evolved enormously. In addition, the European Monetary Union started in 1999. This system is not based on gold, but on a strong (so far) political promise on paper. Apart from wars and the collapse of the centrally planned economic system, this was the most important economic and political event in Europe since the Bolshevik Revolution (1917). A growing number of countries have already entered or intend to join the eurozone.

Contributors to this three-volume Handbook not only survey the literature (look backwards), but also present their own arguments and do not shy away from new ideas and concepts in order to offer a perspective (look forward), as well as explain the issues they think essential for the field. This permitted a constructive interplay between theory and future policy, Each chapter is followed by a summary, hence the reader has a concise overview of its subject matter. The reader cannot fail to notice that a large number of the chapters are 'Eurocentric'. That should come as no surprise as international economic integration has so far the deepest meaning in Europe. However, other regions of the world have not been neglected. As such, it is expected that this Handbook will contribute to a better understanding of the role of international economic integration in economic research and practice.

The salient feature of international economic integration covers such a wide array of topics that it is not possible to do justice to many of them. Those who have tried to edit a volume would soon have recognised that the choice of fields to be covered and contributors ought to mix idealism, pragmatism and time. Our intention, however, was to offer important insights into the most relevant issues for the understanding of the role and influence of international economic integration on the economy. Therefore, this Handbook of readings aims to provide no more than an introduction to the subject, to give a theoretical and analytical framework to the reader, to provoke research curiosity, and to present select analytical studies.

I believe and hope that the *International Handbook on the Economics of Integration* will prove useful to scholars, students, civil servants, business executives and others in widening their knowledge and increasing their awareness of the process of international economic integration in the economy of today and tomorrow, as well as stimulating further research.