CHAPTER 2:

INTERNATIONAL ECONOMIC INTEGRATION AND INDUSTRIALIZATION

Since the 1960s and particularly since the 1980s, international economic integration in the world, especially in the developing countries, has occurred very strongly and rapidly. The process of global economic integration has sharply altered the context in which most governments are thinking about policies for economic development (Rodrik, 1999: 1). The developing countries hope that their economies' integration into the regional and global economy is the surest way to industrialize their economies and to accelerate economic growth. However, economists as well as policy-makers still disagree very much on the strategies of international economic integration\(^1\) for successful industrialization (Krugman & Obstfeld, 1991). In this context, it is widely believed that government intervention in this area is the distinguishing feature of alternative development (Wade, 1990; Chang, 1991; Jomo, 1993). Most economists accept the legitimacy of some intervention in both domestic and international arenas, particularly in response to various market failures, and externalities e.g. infant industries needing help (Dunkley, 2000).

2.1. Definitions

2.1.1. International Economic Integration and Economic Blocs

\(^1\) The strategies of international economic integration refer to industrial and trade strategies because economic integration involves trade and investment. Liang (1992) equates industrial strategies to trade strategies. In the literature, it is common that trade strategies are seen as synonymous with industrial strategies because industrial activities generally involve internationally traded goods (Rokiah, 1994).
International Economic Integration (IEI) describes both a state of affairs and a process. As a state, it refers to fusion of formerly separate national economies. As a process, it usefully signifies the gradual elimination of economic frontiers between countries. Thus, IEI into the world economy is urged in the name of liberalization (Penrose, 1992: 238; Ugarteche, 2000: 107). According to Pelkmans (1984), “an economic frontier is any demarcation over which mobility of goods, services and factors of production are relatively low”. In one sense, integration is a global phenomenon, as the international trade (IT) and foreign direct investment (FDI) intensifies, encouraged by global multilateral agencies, and spearheaded by the activities of multinational and transnational (MNCs/ TNCs). However, IEI is more narrowly defined as attempts by governments to link together the economies of two or more countries through the removal or reduction of economic frontiers under specific integration schemes (Drysdale & Vines, 2000), such as the World Trade Organization (WTO) at the global level, the Asia-Pacific Economic Cooperation (APEC) forum at the super-regional level and the ASEAN Free Trade Area (AFTA) at the regional level.

Therefore, besides international economic integration, there are two concepts which should be distinguished, namely international or regional economic blocs (EBs) and specific integration schemes. An international economic bloc is established by arrangements of two or more countries to promote economic relations by giving economic concessions to each other, such as the reduction of tariffs imposed on the partners’ exports, facilitation of trade and investment with the partner(s) and so on. By its nature, economic bloc initiatives divert economic activity. The purposes of EBs are to foster regional trade and investment relations through a faster pace of liberalization and to create
building blocks for multilateral trade and investment liberalization (*Malaysia MITI Focus*, 1/2001 Issue 5: 2).

While EBs are designed to permit the achievement of greater economic integration, they involve a major exception to the fundamental principle of most-favoured nation (MFN) treatment. In order to address this concern and to ensure that the trading interests of third countries are respected and that such arrangements are compatible with rule-based and open multilateral trading system, they need to be based on formal, legally binding rules, partly because any market-distorting arrangements need to be shored up by regulation and partly because preferential arrangements for trade in goods are not permitted under GATT/WTO in the absence of a formal agreement which meets the provisions of Article XXIV\(^2\) (Drysdale & Vines, 2000: 103-4).

\(^2\) The WTO allows the formation of EB under three sets of rules:

(i) Article XXIV of GATT/WTO (1994): The GATT/WTO recognizes that the purpose of EB (FTA) should be to facilitate trade between the constituent territories and not to raise barriers to trade with countries outside the FTA. Accordingly, the provisions stipulate that: (a) Duties and other regulations of commerce for non-FTA members in each of the constituent territories should not be higher or more restrictive than those levels existing prior to the formation of the FTA; (b) Duties and other restrictive regulations should be eliminated with respect to substantially all the trade between the constituent territories in products originating in such territories.

(ii) The 1979 Decision on Differential and More Favorable Treatment, Reciprocity and Fuller Participation of Developing Countries (Enabling Clause) provides the legal cover for developing countries to enter into arrangement for mutual reduction or elimination of tariffs and NTBs, subject to some conditions imposed under Article XXIV. The provisions of the enabling clause are less restrictive, as it does not call for the arrangements to substantially cover all sectors.

(iii) Article V of GATS: This provision allows WTO members to enter into agreements liberalizing trade in services. Similar to provisions for trade in goods, the conditions include: (a) Substantial sectoral coverage,
Of course, some blocs are more integrated than others, but most efforts for regional integration within economic blocs may be expected to lower or eliminate barriers to trade and investment to harmonize member countries' domestic regulations, practices and procedures, and to seek a higher degree of policy coordination. These efforts have aimed, on the one hand, at protecting industries of the bloc's economies from outside furious competitor at the global level, and, on the other hand at promoting liberalization and facilitation among member countries at the regional level (Yamazawa, 2000). Consequently, someone could say that the moves for promoting liberalization and cooperation under global integration are both slower and weaker than the push for regional integration, implying that reaching global economic integration is a long and laborious process, and regional economic integration is seen as a practical shortcut to this end.

Regional economic blocs have proliferated rapidly since the mid-1980s in various part of the world. Over 80 economic blocs have been reported to the GATT/WTO under article XXIV between 1947 and 1994. Many arose during the 1960s and second generation during the 1980s and 1990s (Pelkmans, 1997). A larger number of blocs have

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in terms of number of sectors and volume of trade, with no a priori exclusion of any mode of supply; (b) Elimination of substantially all discrimination within a reasonable time frame; and (c) No raising of overall barriers levels to members outside the FTA (Malaysia MITI Focus, 1/2001 Issue 5: 2-3).

However, within the bloc, member countries have only liberalized selectively, meaning some infant industries have been protected and others have been liberalized.

The European Union (EU) now has 15 members and is moving towards the adoption of a single currency; The free trade area between the United States, Canada, and Mexico was named the North American Free Trade Area (NAFTA), while Chile also expected to join before long; ASEAN countries have created an AFTA; countries in Asian-Pacific region have established APEC; four Latin American countries, namely
been established, not only between developing countries, but also between developed ones, over the last thirty years. In identifying the reasons for this increase, the first place to look is at corporate liberalization and government responses to it. In responding to the corporate mobility, governments are trying to sustain economic growth, to implement industrialization at home and to expand income and employment by seeking to attract both indigenous and foreign firms. They are having to dismantle impediments to trade and investment, and standardize the regulations and practices that affect corporate activities, not only to attract foreign firms but also to keep their own indigenous firms from relocating to other countries where the business climate is better.

Economic blocs, at a political or foreign policy level, necessarily entail playing favorites and risk reducing international relations to mutually self-destructive factionalism of the kind so dramatically evidenced in 1930s (Aho & Ostry, 1990). From the economic perspective of Jacob Viner (1950), economic blocs, whatever their trade expansion properties with respect to intra-regional trade, almost necessarily also entail some trade diversion, thus distorting the efficient global allocation of resources, and hence, reducing global welfare. But this said, the question must be asked, “compared with what”. Compared to complete, undistorted global free trade, economic blocs are clearly second best\(^3\). But compared with the world trading system that actually prevails or is likely to prevail in the foreseeable future, the case against economic blocs is not so clear.

In this second best world, Lawrence & Litan (1990) provide a balanced

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Argentina, Brazil, Uruguay, Paraguay have joined together to form MERCOSUR; and there are moves afoot for regional integration among developing countries of the Middle East, Africa, and South Asia.

\(^3\) Economic blocs have come to be regarded as a good illustration of the theory of second best, where two or more obstacles to the achievement of a Pareto-optimal position exist, the removal of only one or some of them do not necessarily improve welfare.
assessment of their strengths and weaknesses. In the end, their assessment is cautiously positive. Central to this assessment is, on the one hand, their view that economic blocs may be able to achieve a deeper degree of integration than the multilateral system (negotiation typically involves a much smaller number of “like-minded” nations and the necessary centralized or federalizing policy-making, and enforcement institutions are more likely to emerge); on the other hand, their view that the trade diversion potential of trading blocs is often over-stated, given both the size of inherent intra-regional trade flows involved, and the empirical evidence on the importance of extra-regional trade to all of the major regions that might conceivably become involved in the economic blocs. That is, it is reasonable to assume (or hope) that economic blocs will remain “open”, rather than become closed.

Lawrence and Litan give their relatively positive view of economic blocs as conducive to deeper economic integration because negotiations occur among fewer and more like-minded countries than in the multilateral system. Under these circumstances, countries will be more willing to cede the kind of political sovereignty to federalizing central institutions that is required for deeper economic integration. Then presumably, once these economic blocs have achieved a high degree of economic integration, it is assumed that negotiations between a handful of major economic blocs, all oriented towards progressive trade and investment liberalization, will be conducive to inter-regional economic integration. However, according to Trebicock & Howes (1995), the notions of Lawrence and Litan about this scenario are very sanguine for the following reasons:

First, Lawrence and Latin would acknowledge many actual or potential regional economic blocs offer modest prospects for intra-regional trade expansion, even setting
aside their effects on external trade. This is true for actual or potential economic blocs in Africa, Latin America, the South Pacific and the Caribbean, where the similarity of natural endowments often sharply limits potential mutual gains from trade, although the rapid growth in intra-Asian trade suggests more potential for regional trade in manufactured goods.

Second, once one contemplates more ambitious regional economic blocs, it is difficult to imagine scenarios where economic blocs are not dominated by one major economic power. It is superficially attractive to characterize the multilateral system as afflicted by the convoy problem, in which the least willing participant determines the pace of negotiation (the speed of the convoy moving toward free trade is limited by the speed of the slowest ship) (Wonnacott & Lutz, 1989). This can be contrasted with the regionalist alternative evoked by Lawrence and Litan through the much more appealing metaphor of geese migration, with the major economic power (U.S. or Japan) as head goose flying in a V-formation with a gaggle of other smaller countries in the same formation eagerly striving to keep up the pace at least towards regional economic integration.

Third, it is highly speculative to assume that following deep regional integration, regional economic blocs will then readily move to inter-regional economic integration through negotiation with other trading blocs. It is easy to assume that if political forces within each of these blocs have been amenable to regional liberalization and perceive the economic gains associated therewith, political forces would as readily perceive the virtues of just keeping on going and integrating inter-regionally. But the problem here is that regional patterns of integration and specialization that develop may (depending on how much trade diversion is created) significantly exacerbate the adjustment cost of subsequent inter-regional integration where different patterns of integration and
specialization may be entailed. Moreover, regional economic blocs unquestionably place a premium on foreign investment relative to foreign trade (partly because of its domestic employment-enhancement effect) and as foreign companies, principally MNCs, establish substantial presences in each of the major economic blocs, a major political force for broader trade liberalization is attenuated (so called "cooperative protectionism").

Fourth, one should not underestimate the sequencing problems in maintaining open regional economic blocs, in the sense of remaining open to membership by subsequent parties. First movers in such an economic bloc face considerable uncertainty in determining the value of the preferences they are receiving in return for putatively deep concessions of their own when these preferences may be eroded by subsequent admission to the bloc. This will cause countries to be more reluctant to enter into a bloc in the first place, or to make deep concessions if they do, at least without the right of veto on new membership (creating hold-out problems). Alternatively, negotiations with all perspective members will need to occur simultaneously, but in this event, the many problems said to afflict multilateral negotiations will tend to emerge.

However, economic blocs with specific integration schemes involve both the liberalization of trade and investment implemented by the elimination of tariffs, NTB and other policy measures among member countries and protection infant industries of the bloc from outside severe competitiveness.

2.1.2. Classification of International Economic Integration Schemes

The members of an international economic bloc agreed to sign and to implement the agreements on the economic concessions to each other, called specific integration
schemes. Normally, a specific integration scheme involves liberalization and facilitation of trade and investment among member countries of an economic bloc. As a result, it could be said that trade and investment liberalization and international economic integration are two sides of the same coin. Regional and global economic integration has accelerated liberalization of trade and investment. In turn, trade and investment liberalization has broadened and deepened international economic integration.

Integration schemes reflecting differences of purpose vary in scope and ambition. Following Balassa (1961), several stages or levels of integration may be distinguished:

(i) A free trade area (FTA) allows member countries to remove tariffs and quotas on imports on their partners’ goods and to retain their own restrictions on imports from non-member countries.

(ii) A customs union (CU) goes further than a FTA in that member countries apply a common external tariff on goods from outside the CU. This simplifies the treatment of goods within the CU - regardless of origin, all goods circulate free of tariffs and quotas.

(iii) A common market is a CU in which there is also the free movement of factors of production - labor and capital.

(iv) An economic and monetary union (EMU), besides the features of a common market, has a single currency and monetary policy, where major economic policies are coordinated

According to Hince (1994), this classification, though useful analytically, corresponds only partially to economic reality. Since non-tariff barriers are now more important trade impediments than tariffs, a CU, which fails to liberalize beyond tariffs and quotas, will remain fragmented along national lines. Also, it may be questioned whether FTAs, CUs or common markets are now viable if they do not include some degree of
policy cooperation or coordination, particularly in relation to competition policy. Indeed, it is arguable that integration schemes are inherently unstable, obliging member countries to constantly take further measures or risk failure. This is because interest groups who lose one form of national protection, such as tariffs, will lobby governments for alternatives like state subsidies.

Although there are so many economic blocs with various degrees of economic integration, all economic integration schemes affect the economies of the member countries through three main channels (Brown and Stern, 1989):

(a) *Inter-sectoral specialization effects*, as tariff adjustments lead to a once-for-all (static) re-allocation of a country’s resources among sectors.

(b) *Rationalization effects*, as production is re-organized to take advantage of economies of scale and is spurred to greater efficiency by a sharper competitive environment; and as integration, where there are external economies of scale, may stimulate a higher growth rate by increasing the returns to capital, thereby inducing greater capital formation (Baldwin, 1992).

(c) *Macro-economic effects*, as increased trade and investment affect economic variables such as growth and inflation.

Until recently, most theoretical work on economic integration focused almost exclusively on the static specialization effects, even though it was widely accepted that dynamic aspects were potentially more important. This static analysis has been developed mainly through the theory of free trade areas and customs unions. As noted above, customs union (CU) is a group of countries among which there is free trade and which have a common tariff barrier against the rest of the world, whereas free trade area (FTA) shares the feature of internal free trade, but does not involve the members standardizing
their tariffs against the rest of the world. But the theory of customs unions and free trade areas is otherwise almost identical (Williamson J. & Milner C., 1991: 32-6), and both FTA and CU may lead to the phenomenon "trade deflation" (Ariff, 1992) (more details in Appendix 4). Within this definition of free trade areas and customs unions, both the global integration schemes of the WTO and the regional integration schemes of APEC and AFTA can be considered economic blocs operating on the principles of free trade areas as well as customs unions, meaning promotion of trade and investment liberalization among member countries.

2.2. Free Trade Area and Customs Union Theory

2.2.1. Static Effects of Free Trade Areas and Customs Unions: The Standard Analysis

The central concepts of the theory of FTA/CU (hereafter called blocs) introduced by Jacob Viner, are trade creation and trade diversion. Trade creation, which occurs when a country starts to import a good that it previously produced at home, implies that the country has replaced expensive (domestic) supply by cheaper (partner-country) imports as a result of the abolition of tariffs in an intra-regional economic bloc. It means that trade creation produces a welfare gain. Concomitantly, trade diversion occurs when a country starts to import from a partner country a good that it previously imported from the outside world as a result of the elimination of tariffs in imports from the partner. Trade diversion will result in a net welfare loss, if the country has replaced cheap imports from outside the

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6 Hereafter, we only consider integration into the WTO, APEC, and AFTA as compatible with trade and investment liberalization among member countries.
economic bloc with more expensive imports from its new partner; and a net welfare increase will result, if the reverse condition applies.

As a branch of international trade theory, FTA/CU theory shares the standard assumptions of that theory, to which specific assumptions are added (see e.g. Pelkman, 1984: 8). Thus, mainstream FTA/CU analysis focuses on a world of three countries, two of which are the home (H) and partner (P) countries forming a FTA/CU, with the rest of the world (R) being excluded. The home country (H), being small, faces a completely elastic partner (P) and rest of the world (R) supply. It is assumed that the tariff in the H, taken to be an importer, becomes the common external tariff of the FTA/CU, and that there are no other trade restrictions. Production of homogenous goods in H faces rising marginal costs and perfect competition prevails throughout. There are no externalities. Welfare effects are analysed in relation to three groups: consumers and producers (whose welfare is reflected respectively in the consumer surplus and the producer surplus) and taxpayers (who receive tariff revenues). Net welfare effects can be assessed by assuming that a system of compensation is possible. There will be four cases as follows:

1. It is assumed that we consider the case where H initially applies a non-preferential tariff \( p_1p_2 \) (in Figure 2.1), then, a price is secured in H at \( p_2 \). An FTA/CU formed between H and P gives consumers in H access to tariff-free imports from P, lowering H’s price to \( p_2 \). Consequently, production of \( q_1q_2 \) in H is displaced by low-cost production in P, and consumption increases by \( q_3q_4 \). Imports rise to \( q_4q_4 \) and now come exclusively from the partner country P. The extra trade (imports of \( q_4q_2 + q_4q_4 \)) represents trade creation. Imports of \( q_4q_4 \) from the rest of the world (R), which switch away to P, a higher cost source of supply, are considered trade diversion.
Figure 2.1: Static Effects of FTA/CU Formation
How is welfare in H affected by these changes? All imports now come from tariff-free sources in P, hence taxpayers will lose the tariff revenue of \( (c + h = q_A \times p_1 p_2) \). The lower price will increase the welfare of consumers, measured by the gain in consumer surplus of \( (c + d + e + f) \), but will leave producers worse off by area \( (c) \), which is the fall in producer surplus. The net effect in H can be expressed as:

\[
(c + d + e + f) - (e + h) - (c) = (d + f) - (h).
\]

This indicator is, in general, indeterminate.

The component \( (d) \) and \( (f) \) correspond to the trade creation gain, with \( (d) \): the production effect as higher costs in H is replaced at the margin by lower cost production in P; and with \( (f) \), the consumption effect as the distorting effect of tariffs on consumers in H is reduced.

Area \( (h) \) is the trade diversion loss, reflecting the deterioration in H’s term of trade as imports shift to a higher-cost source.

2. This assessment of the welfare effects of FTA/CU formation is based on the assumption that the initial tariff in the home country H is \( p_1 p_1 \). Suppose, instead, that the pre-union tariff is \( p_1 p_2 \), the minimum prohibitive tariff. Since there is no import at the price level \( p_2 \) the consumer surplus is:

\[
(a + b + f + e + d + c).
\]

and the fall in producer surplus is:

\[
(a + c).
\]

Then, net welfare is: \( (b + d + e + f) \).

This FTA/CU formation can only result in trade creation because before and after FTA/CU formation, the home country H does not import any goods from the rest of the world, R.
3. Similarly, if the price of the R supply had exceeded that of the partner P, then only trade creation could arise from FTA/CU formation because the H always imports goods from the cheapest source in the world.

4. Alternatively, with an initial import tariff in the home country H of $p_1p_2$, the FTA/CU only results in trade diversion, producing a welfare loss of $(g + h + i)$ for H because after FTA/CU formation, H will lose the tariff revenue of $(g + h + i)$, which H still got before FTA/CU formation due to importing goods from R at the tariff rate of $p_1p_2$.

From the above, it could be said that the relative magnitude of trade creation and diversion effects will be influenced by a number of factors such as the size and membership of the FTA/CU (the larger the FTA/CU and the more industrialized the countries in the union, the greater the likelihood of trade creation predominating), and the degree of overlap in members’ industrial structures (the greater the overlap and the degree of substitutability in production, the lower the possibility of trade diversion) (see more in Hazelwood, 1987). This means that Vietnam will get more welfare when she integrates into AFTA (degree of overlap and substitutability is high), APEC and the WTO (APEC and the WTO are large unions and there are many more industrialized countries in them).

2.2.2. Complements to the Standard Analysis

It should be noted that Viner’s analysis is most suitable under constant costs of production and perfectly inelastic demand. However, these examples cannot be used to make any general statement about the economic desirability of FTA/CU although they illustrate the basic Viner proposition. According to Meade (1955), Viner was vague about the assumptions underlying his analysis. Meade (1955), Gehrels (1956) and Lipsey
(1960) pointed out that relaxing the demand assumption opened up the possibility of a further source of gain—from the consumption effect. The removal of tariffs on imports from partner countries leads to a fall in prices paid by the home consumer due to economies of scale, and if demand is not completely inelastic, the removal of tariffs may also lead to a rise in the quantity consumed. This consumption effect is beneficial to the extent that relative prices in the home country now more accurately reflect opportunity costs in the world market. Whereas Meade (1955) described the associated increase in imports as trade expansion, Johnson (1960) argued that both trade creation and trade diversion may have consumption as well as production effects. It is even possible that, contrary to Viner’s view, a purely trade-diverting FTA/CU could increase welfare if the consumption gain exceeded the term of trade loss (Lipsey, 1960). In other words, if there is sound domestic economic policy, a purely trade-diverting FTA/CU could also increase welfare.

Viner was aware of the argument that the creation of a FTA/CU by increasing the size of the “home” market might enable economies of scale to be more fully exploited, but was doubtful of its empirical importance. Corden (1972) formalized the cost reduction effect of FTA/CU formation in the presence of economies of scale. He used the Cooper and Massell (1965) assumption that the rest of the world (R) applies a non-preferential tariff of \( p_R p_2 \) (in Figure 2.2). The effect of this assumption is to create two world prices: a world import price \( (p_m) \), at which imports may be purchased, and a world export price \( (p_x) \), which will be received on exports to R, and which will be below \( p_m \) by the amount of the R tariff of \( p_R p_2 \). The gap between \( p_m \) and \( p_x \) may be further widened by transport costs (since the blocs are typically formed between neighbouring countries, transport costs are likely to be greater for R than between bloc members).
Figure 2.2: Economies of Scale of FTA/CU
Corden assumes that both H and P have a single actual or potential producer who faces a declining average cost supply curve AC. In the Figure 2.2, AC reaches a minimum above the $p_x$ price beyond the size of the national markets. Pre-bloc production is only possible with a tariff $p_xp$. There are two situations to be considered:

(i) Each country supports its own pre-bloc production with a tariff of $p_xp$, such that the producer can realize a price equal to the average cost. Bloc formation allows one producer (say the H producer) to supply the whole market, and thereby reduce average costs. With an unchanged tariff, the price would remain at $p_x$ and the bloc consumption would be $q_{it}$. Average costs on $q_{it}$ would be $p_x$ and excess profits of $(r + s)$ would accrue to the producer while consumers and taxpayers would be unaffected. The net gain to H is $(r + s)$. In P, production ends but there is no producer surplus loss given the downward sloping cost curve, nor are consumers and taxpayers affected. With a zero welfare effect in P, the bloc must gain because of the cost reduction effect in H.

(ii) Suppose that only H had a pre-bloc producer. P receives tariff revenue $(s + t)$ on its imports of $q_x$. Bloc formation has the same effect on H as in the previous case (involving a gain of $(r + s)$), but in P, there is now a loss of tariff revenue $(s + t)$ as imports are switched from R to H (trade diversion). For all member countries, the welfare effect of bloc formation is indeterminate $(r + s) - (s + t) = (r - t)$. Hence, in this case, exploiting economies of scale more fully could be a motivation for bloc formation, but this depends on the balance between the cost reduction effect in H and the trade diversion for P. The balance is more likely to be favorable where the number of producers declines and where economies of scale are pronounced. In favorable cases (with average cost curve $AC_2$), costs could be lowered sufficiently so that no common external tariff would be required.

Apart from Corden's argument on the cost reduction effect of bloc formation in
the presence of economies of scale, Kemp and Wan (1976) argue that a bloc is always potentially beneficial to its member countries. It may be illustrated by considering a bloc, formed by two countries that, by coincidence, have the same tariff rate as the bloc’s external tariff rate. The expansion of trade between the member countries represents a mixture of trade creation and trade diversion, and as for the static effect discussed earlier, the welfare consequences will, in general, be ambiguous. However, Kemp and Wan argue that member countries can be certain of gaining if they set an appropriate external tariff rate. To do this, they must reduce the tariff rate so that their trade with non-member countries is kept at the pre-union level, thereby ruling out trade diversion. At the new lower tariff rate, the offer to non-member countries is unchanged and consequently the terms of trade with the outside world do not alter. With no trade diversion and unchanged terms of trade with non-member countries, but with trade creation among members, bloc formation must benefit the members. If the bloc sets a different tariff rate from that described, this must be because it offers yet higher welfare. Thus, Kemp and Wan’s analysis demonstrates that a bloc is always potentially beneficial.

From a non-member country perspective, Kemp & Wan (1976), Vanek (1965) and also Ohyama (1972) have shown that bloc formation need not be damaging provided that a bloc’s external tariff is set at a rate which avoids trade diversion. If this principle could be applied to all blocs, there would be an incentive for blocs to form and to amalgamate, eventually culminating in global free trade. However, in the absence of an international enforceable rule to prevent trade diversion, a bloc is likely to set external tariffs at higher levels in order to take advantage of the greater size of the union and to thereby secure improved terms of trade. This would prompt non-member countries to respond by forming blocs themselves. Without co-operation, external tariffs are then likely to be raised,
reducing trade between blocs. Krugman (1991) considers how the number of blocs into which the world is divided might affect world welfare. He finds that as the number of blocs decrease, so also does world welfare because of mutual trade diversion, reaching a minimum point with three blocs. A single bloc (global free trade) is, of course, optimal. As Krugman acknowledges, these results may not be very robust. In particular, if trading blocs are formed by natural trading partners (between whom transport costs are low), the welfare outcome may be much more favourable.

2.2.3 Dynamic Effects of Free Trade Area and Customs Union

So far, only the static effects of bloc formation have been considered. But dynamic effects are potentially more significant because of their cumulative nature. Dynamic effects are defined, according to Kreinin (1974), as “changes in growth rate resulting from expansion in size of the market and the attendant addition of productive resources”. Dynamic effects are particularly associated with increased scale and with increased competitive pressure following the removal of trade barriers. Increased competition should reduce monopoly rents and stimulate managerial efficiency. However, until recently, a satisfactory framework for analyzing these effects was lacking. Up to now, there are two types of models incorporating imperfect competition that have emerged, one based on monopolistic competition and the other on an oligopolistic market structure. Their application to bloc problems, though still in its infancy, is beginning to produce some interesting results.

1. Ethier and Horn (1984), in their monopolistically competitive model with a high degree of symmetry, assume that two countries forming a bloc, each produces a range of
differentiated manufactured goods with economies of scale and food at constant costs. The rest of the world R only produces food (in fixed quantities), which is exchanged for manufactured goods. Consumers prefer variety, consuming a little of each available type of manufactured goods. Ethier and Horn comment on two experiments they conducted with their model.

First, they consider the impact of a slight increase in the common external tariff on food imports. They conclude that the bloc will produce fewer varieties of differentiated goods as resources are sucked into increased bloc food production, although the output of each of the remaining varieties will be unchanged. The shift in demand by the bloc away from food turns the terms of trade in favor of the bloc. They conclude that whereas the direction of the net change in benefit for any member of the bloc is ambiguous, the rest of the world R loses both from the terms of trade effect and the reduction in product variety.

Second, they consider the effects of erecting a marginal internal barrier to trade within the bloc, with each member trying to protect its own manufacturing. Each bloc member will divert spending from its partner’s manufactures to its own. The number of varieties, and hence, manufactures produced, will, as before decrease: the attempt to protect manufacturing has the opposite effect of shifting resources into agriculture. Again, the effect on the welfare of each bloc member is ambiguous, as is the effect on non-member(s) whose consumption of manufactures increases, but comprises fewer varieties.

2. Smith and Venable (1988) model integration effects under oligopoly. They examine how national trade barriers influence the behaviour of oligopolistic firms in particular industries. Firms decide how many varieties, and how much of a product to sell in each market. Their decisions are based on equating perceived marginal revenue with marginal cost in each market, where the slope of each firm’s perceived demand curve
depends on the number of product varieties and the firm’s share of the market. They conclude with the establishment of the single market program in Europe in 1992, with welfare effects obtained for the examined industries.

Krugman and Venables (1990) used both monopolistic competition and oligopoly structures to examine a neglected issue in bloc analysis: the economic geography of blocs, particularly the relationship between a central country and a peripheral country. Their model explores a fundamental ambiguity in the integration of a low-wage, small (peripheral) country and a high-wage, large (central) country. The removal of trade barriers makes it more attractive to move production out to the low-wage periphery, but at the same time, the cost disadvantage of serving both countries from production in the center is diminished. The extent of barrier removal (integration) is shown to be critical: while the complete removal of obstacles to trade always raises the competitiveness of the periphery, their partial elimination may have a perverse effect.

There is another promising way for understanding the dynamic effects of integration provided by Rivera-Batiz and Romer (1991). Endogenous growth models have examined how pure scale effects from integration could affect both the level and growth of output in a pair of similar economies. Technological progress is represented by the invention of new types of capital goods. Integration, which permits a freer flow of ideas and a greater spillover of knowledge, could speed up growth, but only under certain specifications of the production function for the design of new capital goods. Rivera-Batiz and Romer suggest that the fundamental gain from integration is that the fixed cost of a new design needs to be incurred once, instead of twice, in separate economies. This can be ensured by allowing a free flow of goods and a free flow of ideas under certain specification of the model.
2.3. Conclusion

One of the main purposes of international economic integration for developing countries is to correct trade imbalances and to promote the industrialization of their economies\textsuperscript{7}. A prescription for this purpose is either that the rate of increase of demand for imports falls due to import substitution, or industrial exports have to be added to the primary exports, or a combination of the two (Prebisch, 1959: 254).

The forming of a free trade area or customs union typically has a trade creation effect (as the elimination of tariffs and non-tariff barriers stimulates trade and investment) as well as a trade diversion effect as protection measures impede trade with outside countries and protect industries of both individual countries and the FTA/CU from severe outside competitor. As a result, not surprisingly, outside countries complain that the FTA/CU is discriminatory\textsuperscript{8}.

\textsuperscript{7} The preoccupation of developing countries' strategies is to encourage the manufacturing sector to develop rapidly because this sector is considered a symbol of national development. Thus, all countries try to demonstrate their strength and independence through conspicuous domestic industries such as steel or petrochemicals or ship-building and so on. Industrializing is an important way to achieve this purpose. The process of industrialization has been impacted upon directly by integrating the national economy into global and regional economies.

\textsuperscript{8} Article I of GATT/WTO calls for most favored nation treatment (MFN) for all trade partners, and Article XXIV expresses the hopes that regional liberalization will lead to global liberalization, allowing regional FTA/CU agreements as exceptions to Article I. However, this exception is conditional on their covering substantially all trade in goods and services, on their setting a clear schedule for liberalization, and on their barriers to non-members being no higher or no more restrictive than before the FTA/CU agreement comes into force. Nevertheless, it is both more realistic and more practical to monitor each agreement to ensure
Empirical studies have shown that the FTA/CU serves to enhance trade and investment among members, but there are no clear cases in which they have a net trade creation effect (net welfare gain). But the advocates of regional integration argue that regional integration will lead to global integration, meaning that expansion of intra-regional trade will give rise to trade expansion worldwide. In fact, to date, no FTA/CU agreement suggests that it intends to stimulate intra-regional activity by shutting out extra-regional trade (Malaysia MITI Focus, 1/2001 Issue 5: 3).

Yet, there have been a number of instances in which other participants have been excluded from certain sectors for the sake of protection of infant industries of FTA/CU economies. Thus, in the presence of oligopoly and scale economies, import protection is not only compatible with, but may also be instrumental for export promotion (Krugman, 1984) because import substitution from outside the FTA/CU is needed, not only for creating export ability, but also for providing the basis necessary for competitive export production. This implies that member countries of an FTA/CU have conducted mix strategies combining protection for selected domestic industries and external liberalization of the other industries.

_{that it does not in fact lead to increased discrimination rather than to trying to regulate the FTA/CU agreement through GATT/WTO._}