



## ARE ECONOMIC INTEGRATION AGREEMENTS DESIRABLE?

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### Abstract

Over the past few decades, economic integration agreements have been taken up by an increasing number of economies as a means to promote the market-opening and rule-making agenda. This has led to several theoretical studies on the desirability of regional agreements. This paper reviews the literature of the pioneering work done by various economists in context of such agreements.

**Keywords:** *Economic Integration, RTAs, FDI*

### Introduction

Economic integration generally refers to a staged process in which a group of countries progressively coordinate or merge their economic policies over time. The purpose of economic integration is to lower trade barriers and other economic obstacles between countries, thereby expanding markets and increasing the trade between the countries taking part in the agreement and reducing costs for both consumers and producers.

Regional Economic Integration Agreement is an economic arrangement between different countries where member countries agree to reduce or eliminate trade barriers and apart from it, the member countries even make an attempt to coordinate their monetary and fiscal policies. Regional Economic Integration is a process where countries work together with each other to lower or remove barriers to the transnational flow of products, people, or capital for the purpose of increasing cross-border trade and investment and raise living standards. According to European Commission, “regional integration is the process of overcoming barriers that divide neighbouring countries, by common accord, and of jointly managing shared resources and assets. Essentially, it is a process by which groups of countries liberalise trade, creating a common market for goods, people, capital and services.”

Over the past few decades, regional trade agreements (RTAs) have been taken up by an increasing number of economies as a means to promote the market-opening and rule-making agenda. This has led to several theoretical studies on the desirability of regional agreements. Numerous research work has been done and there are various opinions. Previous literature on regionalism majorly discusses two important issues. Firstly, whether or not the welfare of the members is influenced by the formation of regional trading blocs and secondly, whether the process of multilateral trade liberalization is encouraged or delayed by formation of such agreements. This paper attempts to summarise the pioneering work of various economists in regard to RTAs. This paper is divided into four sections. First section discusses whether economic integration agreements improve the welfare of participating nations or not. Second section discusses the impact of economic integration on foreign direct investment (FDI) flows. Third section discusses the impact of economic integration on trade. Fourth section gives the conclusion.

### I. Economic Integration: Welfare Improving or Not?

The impact of economic integration on growth and welfare of the country has been subjected to a lot of empirical investigations. This section discusses whether or not integration leads to growth of the economy and welfare of people.

One of the most initial and influential work was done by Viner (1950) in his book ‘The Customs Union Issue’. He stated that any kind of preferential trade was beneficial to international trade as it encourages the specialisation of production in least cost countries. Author also showed that preferential trade not just enhances the wellbeing of the member countries, but also even lowers it by diverting trade to high cost economy from low cost economy. To describe the economic outcome of the regional integration two concepts were introduced by the author namely ‘trade creation’ and ‘trade diversion’. According to Viner, “Trade creation occurs when high cost domestic producer is replaced by a low-cost partner firm and the consumer can buy more at cheaper price” and “trade diversion occurs when the low-cost rest of the world partner is replaced by a high cost partner country and there is a welfare loss for the home country.” Trade creating agreements are favourable to world economy and trade diverting agreements are detrimental to world economy. There were three major shortcomings in Viner’s model. First, it was a partial equilibrium model which did not consider the modern neoclassical trade theory which is centred on the general equilibrium theory. Second, it assumed constant costs of production in trading nations. Third, it could not clarify the situation of large bloc nations of regionalism.

Meade (1955) in his book ‘The Theory of Customs Union’ explained the modern static theory of regional integration arrangements which is an advancement over Viner’s model in many ways. Meade’s analytical

framework included trade in various commodities by various countries. It discarded the Viner's supposition of constant costs of production in trading economies and also identified the need for maintaining equilibrium in international balance of payments. These enhancements to the static theory of regionalism incorporated the chances of spill-over impacts of regional agreements on non-member countries and as well as the reaction of global adjustments to the creation of such agreements on member nations. Meade apart from studying the countries forming a regional integration arrangement also focused his analysis on the economic welfare of the world economy.

Lipsey (1960) apart from looking at the trade creation and trade diversion aspects of economic integration agreements also studied their welfare effects. He explained that the impact of location on the cost of world production along with the utility of world consumption determine the welfare impact of customs union. He described production and consumption effect of customs unions and said that the basic assumption of trade creation is 'good' and trade diversion is 'bad' are no longer valid when consumption effect is allowed. Lipsey in his model explained that the formation of a customs union may lead to an increase in welfare which results only in the diversion of trade from low-cost producers to high-cost producers. Author further explained that the economy whose import trade is diverted might use this welfare gain.

Rivera-Batiz and Romer (1991) stated that regional integration among two or more alike developed nations would lead to rise in the rate of economic growth globally. Authors suggested that by increasing the trade in goods among nations and encouraging flows of ideas across borders, closer integration could be achieved. Empirical research done by the author showed that any level of integration could lead to rise in the long-run rate of growth if it gave a boost to employing increasing returns to scale in the research and development segment globally.

Fung (1992) made an effort to establish the relationship between the regional integration and stimulation of competition. The study used an illustrative model to show that the process of economic integration would promote competition if the foreign firms had low cost production ability. However, regional integration could also impede competition in case the foreign firms had high cost production abilities. Author concluded that the work of policy-makers in respect of competition policy must be implemented even under the regime of liberalization as trade liberalization would not offer competition opportunities all the times.

Gupta and Schiff (1997) analysed the welfare implications for the countries excluded in RTAs. Authors concluded that regional trade agreements may have negative welfare implications for countries outside the agreement but these countries also at times benefits as well from being excluded.

Schiff and Winters (1999) explained that regional trade agreements increase the trade between member countries thereby increasing the trust and lowering the chances of conflicts between them. Authors stated that RTAs are a part of diplomatic ties between countries which attempts to lessen security tensions between neighbouring countries. Authors co-jointly also asserted the significance of non-traditional benefits provided by regional agreements like commitment, signalling and insurance mechanisms.

Thirlwall (2000), Fernandez (1997) and Wacziarg and Welch (2003) opined RTAs can provide helpful economic benefits on top of the direct gains from trade liberalization by lowering such uncertainties and by improving trustworthiness.

Frankel and Romer (1999) asserted that there is a positive link between trade relaxation and growth. Researchers like Rodriguez and Rodrik (2000) and Cruz (2008) are sceptical in believing that expanding trade or increasing openness helps in stimulating growth.

Haveman, Lei and Netz (2001) comprehensively surveyed and did an empirical investigation for determining the relationship between varying levels of economic integration and economic growth. Author concluded that growth in a country is stimulated by general openness of its economy, its membership into a trade block and foreign direct investment flows into the country.

Schiff and Winters (2002) stated that nations can derive huge gains from the cooperation when they agree to share resources like rivers, fishing grounds, hydroelectric power, rail connections or the environment. Authors suggested that such non-trade issues can be addressed through Regional Integration Agreements (RIAs). RIAs assist in effective implementation of cooperation agreements as it addresses the need for specialized institutions to perform the functions of: (i) enforcing the provisions of cooperation agreement, (ii) dealing with the disputes of sharing benefits and (iii) dealing with situations that require the renegotiation of agreements. According to the authors, "the ties of collaboration and frequent interactions at policy-level provided by some RIAs generate practice in shared problem solving and can raise the degree of trust among the parties. On several counts, it might be easier to conclude cooperative agreements among countries if they are members of RIAs... RIAs also provide ready-made institutions and embed cooperation agreements in a wider framework of cooperation." RIAs encourage greater trust by expanding trade between the member nations and by increasing the degree of contact and interaction between their policy makers. Through the former route RIAs help in distributing the benefits of efficiency thus, enhancing cooperation by putting more issues on the table and simplifying compensation problems because different countries are likely to benefit in different areas. RIAs can also help in pushing the arbitrations on regional cooperation forward in a larger institutional structure.

Robinson and Thierfelder (2002) analysed the potential and actual regional trade agreements. They were in support of the formation of RTA's stating (i) domestic policy reforms in conjunction with RTA increase welfare of participating countries, (ii) aggregate trade creation is much larger than trade diversion and (iii) large welfare gains appear in models that incorporate features of new trade theory. They reasoned that changes in the production structure are encouraged by RTA's as countries have a secure access to RTA-partners markets.

Dennis (2006) examined the potential role of RTAs along with the improvements in trade facilitation in enhancing the development prospects of the Middle East and North Africa (MENA) region. Author applied the Global Trade Analysis Project (GTAP) model and information database. He observed a positive influence on welfare of the MENA region due to intra-regional integration as well as integration with the European Union (EU). According to his study the welfare gains from integrating with the EU are at least twice as much as intra-regional integration.

Bhattacharyay (2012) investigated the trends, actions, drivers and prospects of economic progression and expansion for South and South-East Asia until 2030. He concluded that intra-regional trade and domestic demand will improve with the integration of these two regions and also, integration will reduce their dependence on advanced nations. For furthering the integration between the two regions author suggested effective formation of Association of South East Asian Nations (ASEAN) +6 CEPEA<sup>1</sup>. South Asian Association of Regional Cooperation (SAARC) and the ASEAN Secretariat should be strengthened by making more financial and human resources available to them and increasing their responsibility and accountability. Author suggested for increased involvement by South Asian and ASEAN countries within the regional production network by (i) undertaking more economic, and various policy reforms to further reduce tariff and non-tariff barriers, (ii) improving domestic infrastructure and connectivity, (iii) enhancing business environment to invite foreign investment; (iv) building human capital and (v) making a strong governance structure, rule of law and institutional effectiveness.

## **II. Impact of Integration on FDI**

Efforts for the formation of regional integration agreement are an essential feature of current economic landscape that also has an impact on the flows of foreign direct investment. Such agreements can cause the creation, as well as, diversion of investment from restructuring within the integrating regions. Regional integration efforts lead to the growth of intraregional FDI by removing the barriers of investment in different sectors and introducing policies for the national treatment of foreign investors. Extra-regional FDI could increase because of an enlarged market size and also as a result of tariff jumping FDI i.e. import substitution effects wherein external barriers to trade are imposed by regional economic integration agreement. Coordinated efforts to stimulate investment at the regional level can also accelerate investment from outside the region. Regional integration agreements can also divert the investment from the member countries by making exporting more attractive as compared to investing. Since tariffs and other trade barriers are reduced through economic integration, a member country can favour the supply to another member country markets through trade than FDI. This section discusses the various literature establishing relationship between regional integration and FDI.

Blomstrom and Kokko (1997) discussed how the formation of regional investment agreements (RIAs) effect inward and outward FDI flows in the integrating region. They gave a conceptual framework for analysing how RIAs can impact investment patterns among countries. Firstly, trade barriers are main motive for FDI which suggests that intra-regional investment flows might fall but inflows of FDI from “outsiders” into the region could increase if the average level of protection increases as a result of RIAs. Secondly, where the reason for undertaking the projects is to internalise the exploitation of intangible assets, the reduction of trade barriers could fuel overall FDI flows. The inflows of FDI may also go up because as per internalization theory, the larger market makes the region a more attractive location for investment. Thirdly, removing Trade Related Investment Measures (TRIMs), such as obligations for foreign affiliates to meet certain export targets, and by existence of strong Trade Related Intellectual Property Rights (TRIPs), inward investment could be stimulated. Fourthly, establishment of RIAs also generates various dynamic effects that may affect FDI flows like significant efficiency benefits may increase the growth rates of the participating countries over the medium or long term. Also, the firms along with investment bring intangible assets- e.g. technology, which may spill over to local firms and therefore may result in higher growth rates.

Weerakoon (2004) studied the impact of economic integration on SAARC’s absolute and relative growth rates of FDI. Author highlighted that there exists high degree of positive correlation between regional trade liberalization and investment flows.

Aggarwal (2008) examined the impact of expanding regionalism on foreign direct investment flows. The study explained that it is possible to stimulate intra and extra regional FDI flows and economic development in all the economies of the region by forming regional integration agreements. Regional integration assists in using the region’s resources in the most efficient way through additional economies of scale, value addition decrease in investment flows in the region was observed. With upsurge in membership of FTA’s, exporting as compared to investing becomes relatively attractive, which promotes substitution of FDI. Since tariffs and other trade barriers are reduced through RTA’s, integration seems to favour the supply to these markets through trade rather than FDI.

## **III. Impact of Integration on Trade**

Economic integration agreements can either have a positive or negative impact on trade relying on their draft and its execution. Signing of such agreements leads to redirection of trade flows. This redirection of trade flows can either lead to trade creation or trade diversion. As discussed in first section, this concept was introduced by Viner (1950). This section highlights various studies done on the relationship between economic integration agreement and trade.

Hertel et al. (2001) studied the effect of the trade agreements on production, consumption, national income, welfare, trade and FDI. They studied then proposed Japan and Singapore FTA. They used a modified version of GTAP model. Apart from the projected tariff cuts among member nations, they also considered factors like possible benefits by applying similar standards for e-commerce in Japan and Singapore and outcome of relaxing rules overseeing direct trade in services. They found that the impact of this new-age FTA on bilateral trade and investment flows are significant with programmed customs procedure playing the most significant role in propelling the growth of merchandise trade. In contrast to preferential tariff cuts, the contemporary factors of this trade agreement encourage imports from various sources, therefore reducing the issue of trade diversion.

Dee and Gali (2003) used gravity model to examine the effects of the trade and non-trade provisions, particularly those related to investment and services, of Preferential Trade Agreements (PTAs) on the trade and FDI flows of member and non-member countries. Their result supported the already laid theoretical work which says that merchandise trade provisions of PTAs increases trade among members but this is also accompanied by the loss of trade by non-members. In their research they examined eighteen PTAs out of which twelve have diverted more trade from non-members countries than they have created among members countries. Authors also found that FDI responds considerably to the non-trade provisions of PTAs. They analysed nine PTAs for studying the impact on investment wherein, five amongst them suggested that the non-trade provisions resulted in net creation of investment.

Carrère (2006) studied the impact of regional trade agreements on trade flows. Author used gravity model to study seven RTAs comprising 130 countries for the period 1962-1996. Author showed that most of these RTAs generated a significant increase in intra-regional trade beyond levels projected by the gravity model, coupled with a decline in imports from the rest of the world, and sometimes coupled with a decline in exports to the rest of the world, signifying evidence of trade diversion.

Liu (2004) studied the influence of RTAs on trade creation and trade diversion effects of trade using gravity model. Author's study revealed that RTAs like APEC<sup>ii</sup>, CER<sup>iii</sup> and MERCOSUR<sup>iv</sup> are likely to stimulate trade with member nations along with the trade with other trading partners from non-member nations, indicating the sign of trade creation.

Koo et al. (2006) studied the effects of regional Preferential Trade Agreements (PTAs) on agricultural trade. Their result indicated that PTAs lead to rise in volume of trade among member nations owing to both inter- and intra-industry trade and to a smaller degree among non-member nations thereby enhancing global welfare.

Calvo Pardo et al. (2009) examined how the formation of the ASEAN Free Trade Agreement (AFTA) has affected trade flows and trade policies with member and non-member countries. Their study found that the formation of the trade bloc had led to positive impact in fostering the trade flows among members but it was not at the expense of trade with non-members. Authors did not find any evidence to show that preferential liberalisation has led to lower import growth from non-members. This was because AFTA members reduced their trade barriers on imports from non-members in response to lower internal tariffs. Authors concluded that AFTA has been clearly beneficial for the promotion of freer world trade.

#### IV. Conclusion

The analysis of economic integration agreements done by various researchers and economists discussed in this paper suggests that international policy toward regional integration should aim at encouraging economic integration agreements to achieve trade creation and avoid trade diversion, for the sake of members and to minimize harm to excluded countries. Such agreements should permit deep integration, including nation building, between members. RTAs should preserve the effects of previous liberalization efforts taken by the countries and provide credibility for any liberalizations that form part of the RIA. International policy towards regional integration should support liberalizing changes within member countries and in the world trading system as a whole. The instrument we have for international policy on trade blocs is the WTO.

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#### Endnotes:

<sup>i</sup> The Comprehensive Economic Partnership for East Asia (CEPEA) is a Japanese led proposal for trade co-operation, free trade agreement, among the 16 present member countries of the East Asia Summit. All those movements and efforts were taken over by the following Regional Comprehensive Economic Partnership.

<sup>ii</sup> APEC stands for Asia Pacific Economic Cooperation which is a forum for 21 Pacific Rim member economies<sup>[2]</sup> that promotes free trade throughout the Asia-Pacific region. It was established in 1989 in response to the growing interdependence of Asia-Pacific economies and the advent of regional trade blocs in other parts of the world.

<sup>iii</sup> Closer Economic Relations (CER) is a free trade agreement between the governments of New Zealand and Australia. It is also known as the Australia New Zealand Closer Economic Relations Trade Agreement (ANZCERTA) and sometimes shortened to (CERTA). It came into force on 1 January 1983, but the actual treaty was not signed until 28 March 1983 by the Deputy Prime Minister of Australia and Minister for Trade, Lionel Bowen and the New Zealand High Commissioner to Australia, Laurie Francis in Canberra, Australia.

<sup>iv</sup> Mercosur is a South American trade bloc established by the Treaty of Asunción in 1991 and Protocol of Ouro Preto in 1994. Its full members are Argentina, Brazil, Paraguay and Uruguay. Venezuela is a full member but has been suspended since December 1, 2016.

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