Preface

The traditional theory of international economic integration is an elegant and quite convincing academic exercise. Its conclusions are straightforward and offer useful insights into the incentives for and the general consequences of integration. With that in mind, the first objective of this book is to introduce the reader to the area of international economic integration. The other goal, equally important, is to extend the traditional theory of integration by addressing issues that were ignored in the neoclassical model. These include market imperfections such as economies of scale, foreign direct investment, spatial fragmentation of production and an evolutionary approach to the spatial location of firms and industries. This reflects the modern research attitude to trade, competition, investment and spatially fragmented location of production, as well as international supply chains. The analysis is supplemented by numerous examples from the real world in order to provide support for theoretical statements. A quantitative approach to analysis is kept to a minimum; thus it is hoped that the book will be readily accessible to a wide audience.

A presentation of a general theory of international economic integration is not (yet) possible. This is due primarily to the absence of generally applicable theories of international trade and spatial location of production. The neoclassical theory has looked at comparative advantages; hence the standard theory of regional economic integration has largely been presented in such a framework. A modern theory and policy on trade, investment and spatial location of fragmented production chains cannot be separated from competition and industrial policies. New research models have identified other determinants of countries’ trade, investment and patterns of location of production. In a world of imperfect competition, multiple equilibria, various externalities and economies of scale, there are many reasons for trade, foreign direct investment, geographical location of industries and integration, even if countries are identical in their factor endowments, size, technologies and tastes. In such a situation, there are several second-best choices of economic action. This book considers both theoretical and practical economic choices linked with international economic integration.

The analysis acknowledges the importance of the traditional, neoclassical theory of trade: countries trade because they are differently endowed with resources, technology and/or predilections. None the less, such a trade model is more appropriate to trade in simple goods such as wheat, wine or iron ore, while the new theory of trade and strategic industrial policy (as well as evolutionary economic theory) is better suited as a theoretical tool for the analysis of trade in goods such as aircraft and pharmaceuticals, as well as services such as marketing or financial analysis. The new theoretical model supplements the traditional one with innovative qualities, that is, the consideration of market imperfections – in particular, economies of scale, externalities, foreign direct investment, evolutionary economics and spatial location of businesses. Because they are inconsistent
with perfect competition, these issues were omitted from the picture in the traditional model. The new evolutionary model questions the conventional argument that free trade is always an optimal economic strategy. When a particular situation is compounded by market imperfections, economic integration/regionalism can sometimes make good sense.

Once trade and competition take place in an imperfect economic environment, solutions to economic problems are no longer unique. The outcomes of economic games depend on assumptions about the past, present and expected future complex behaviour of players. In these evolutionary circumstances and with multiple equilibria, economic policy (intervention in the form of integration) may simply add an adjustment mechanism to the already highly imperfect and suboptimal market situation. Economic policy and integration may also be abused by those who rely on certain (incomplete or distorted) economic facts in order to pursue rent-seeking objectives. When the economic situation is not simple and straightforward, many outcomes become possible, but not equally desirable. Therefore the new model of economic integration is a mix of various theoretical approaches to trade, competition, investment and spatial location of economic activity. The new theory does not argue that the classical model is wrong, but rather that it is not necessarily correct. Market imperfections need not be rectified by new barriers to trade, factor mobility and foreign investment, but rather by domestic policies that alleviate the problem (of competitiveness) at its source, such as the supply of certain types of labour (education) and venture capital.

Contrary to widespread belief, the new model does not give carte blanche to medium- and long-term protectionism, because a cycle of retaliation and counter-retaliation makes everybody worse off. Intervention may be employed under certain conditions as a useful short-term economic policy tool. All developed countries have used it at some crucial point in their past. They use it or threaten to use it even at the present time, for example in the textile, iron, steel and food industry. However, governments do not always have all the necessary information and tools for intelligent intervention, but nor do free markets always bring desirable solutions. The new model argues that, with a bit of astute intervention, under certain conditions, economic policy may improve a country’s national and international economic position.

Treatment of the theory of international economic integration has been basically Eurocentric, because integration had its deepest meaning there. A specific economic integration in Europe is the product of specific, even unrepeatable, circumstances after the Second World War that do not exist elsewhere. None the less, Europe is, actually was, the integration model that a number of other integration groups try to emulate. This was the case, at least until the deep eurozone crises that started in 2007 and has no end in sight. While the European Union (EU) deals with reforms of Byzantine legal forms and structures, South-East Asia is dealing flexibly with the substance of reforms in production.

There are no big theoretical differences between integration among developed and among developing countries. The arguments in favour of integration are the same. What may differ are the intentions and ambitions of countries, as well as the starting base. In spite of the poor achievements of previous integration efforts by the developing world, those countries may still wish to employ international economic integration as a part of their development strategy, but perhaps by no longer following the exclusively the South–South integration path as in the past, but rather also trying North–South
integration as exemplified in the case of Mexico’s 1994 free trade agreement with the US and Canada, as well as the 1995 customs union deal between Turkey and the EU.

Most of the tariff-related trade liberalisation and integration efforts were exhausted in the post-Second World War period until the Doha Round of trade liberalisation negotiations under the auspices of the World Trade Organisation (WTO). Tariff liberalisation is no longer the principal driver of integration. Integration and trade liberalisation face new dimensions and challenges in the twenty-first century. This novelty is based on the easing of regulation, especially tough behind-the-border domestic regulation, which the traditional (tariff-related) integration theory cannot tackle to the full extent. Reduction in overall trade costs, trade facilitation and smooth operation of spatially fragmented production and supply chains are the new leitmotifs for integration. This is most often led by corporate interests that may try to eschew the protection of workers, consumers and the environment. These firms may have already won most of the benefits that a reduction in tariffs may offer them. They are now in the camp of trade facilitation that argues in favour of the smooth operation of transport, trade and customs clearance in order to lower financial and time-related trade costs. Spontaneous firm-led cooperation is the template for integration in South-East Asia, often without any formal institutions and inter-state agreements. This template may provide an example to follow in other regions in the world.

Various integration deals are booming in number throughout the world. This is one of the most remarkable features in the world economy since 1995. These deals may fragment the multilateral trading system. The number of integration deals is, however, not the measure of their real impact, as the vast majority of those deals are ineffective. In addition, certain integration deals are not offered to advance trade, but rather to further non-trade goals such as the war on drugs.

The future relevance of and impact of multilateralism by the WTO or its drift into oblivion would be shaped and challenged by external events such as the three mega trade deals that are in the making: the Trans-Pacific Partnership, the Regional Comprehensive Economic Partnership and the Transatlantic Trade and Investment Partnership. Tariffs are already low, so the big (American-led) international trade wheels may be looking for real custom-made solutions to non-tariff barriers, standards and trade and investment issues outside the WTO. This will be a favourable development if the new standards and regulations are not skewed by corporate lobbies. The danger is that the law-making in the mega trade deals is hijacked by corporations (the wealthy).

These new mega trade deals in the making should be open to other countries that wish to join, while the new trading blocs should be included in the multilateral trading system to avoid the creation of a parallel international trading system. The WTO may use its convening authority to exchange views and inform (if not direct) the member countries about these new developments. If, however, the post-Doha WTO cannot handle new issues satisfactorily, it seems possible that the regional trade organisations and various bilateral deals may take their own, potentially uncoordinated, path.

The book is organised as follows. After the Introduction, which presents the basic notions related to integration (Chapter 1), Chapter 2 deals with dissipating multilateralism, expansion of integration deals, emergence of the mega integration deals and marginalisation of the WTO. Chapter 3 overviews issues related to customs unions and free trade areas, which are the most rigorously developed part of the theory of international
economic integration. The analysis is carried out through static and dynamic approaches, as well as in partial and general equilibrium frameworks. Increased competition on a secured and enlarged market by means of integration, specialisation and returns to scale receives special treatment, as these are the most important dynamic effects. A discussion of adjustment costs suggests that they do not always represent a serious barrier to integration, especially in the medium and long run.

Chapter 4 is devoted to common markets. Factor (labour and capital) mobility lies at the heart of the analysis. Labour migration, including a number of controversies surrounding this issue – particularly which country (sending or receiving) benefits more from integration (or how much) – is outlined in the context of Europe. Prospects for increased foreign direct investment activity and operations of transnational corporations are analysed with respect to integration arrangements of both developed and developing countries. Discussion is supported by statistical data on foreign direct investment in the EU.

Chapter 5 covers the controversial issue of globalisation. This term is not well defined: it is overused and often abused. It means different things to different people and professions, and it changes over time. The chapter observes that globalisation is in many respects old wine in new bottles. However, a new Asian face of ‘globalisation’ disrupts an important part of the old international economic order, and the West may ask if it lost control over the globalisation forces.

Chapter 6 examines economic unions. Monetary and fiscal policies are considered in turn. The point is that these policies in an economic union can be defended by the same arguments that are used to justify similar policies in a single country consisting of several regions. Monetary policy is the area where the effects of integration are felt first. The eurozone – its origin, controversies and uncertain future – is considered in detail. Fiscal policy refers to taxation and budgetary problems among countries.

Existing and emerging integration schemes and their experiences are examined in Chapter 7. Integration schemes are distributed on the basis of geography. The chapter demonstrates the ways, means and certain achievements of larger-scale integration between developed and some less-developed countries. There are also references to the emerging mega trade deals that aim to create a new set of trade rules for the coming decades outside the WTO. The American policy is to set those new rules according to the American liking, but without the involvement of China (international mega-trader), and make China either accept the already set new rules (capitulate) or be excluded. This is faulty and dangerous, as China, as the principal world producer and trader, may be the ‘natural heir’ of the American policy of global liberal trade. China may also develop its own parallel trading and payment system.

Chapter 8 deals with the measurement of the effects of international economic integration. There are serious methodological limits to the quantification of these effects, as well as interpretations of the results of studies. Most importantly, it is not yet possible to create a reliable counterfactual situation that would simulate scenarios occurring with and without integration. It is stated that the end result of estimations is an amalgam of various effects, some of which have nothing to do with integration. Hence the theory of international economic integration is in certain dimensions more intuitive than conclusive.

Chapter 9 concludes the book and argues that regional economic integration is now
here to stay.\(^3\) Even though the results of the Uruguay Round provided a major impetus to multilateral solutions in international trade, regional trade arrangements (mainly free trade areas) continue to proliferate. The new post-Doha Round WTO is unlikely to stop that trend. Multilateral liberalisation and regionalism could be mutually reinforcing, provided that the regional integration schemes adopt a relatively liberal external trade and investment policy, and that they cooperate. On those grounds, and if these conditions hold, integration arrangements may be a favourable development for the world economy. It is important to bear in mind that countries grow richer together in the medium and long term, not at each other’s expense.

I hope that the book will be of interest to economists specialising in international economics, international trade and integration, spatial economics and European studies. However, if it also attracts the curiosity and attention of those studying economic development, international business and policy makers, then this is to be welcomed.

NOTES

1. One may even argue that both the classical and the new theory of trade and spatial economics are limited to a few special cases. None the less, one should not disregard the consideration of extreme cases, as many useful things may be learned from the analysis of such examples.

2. Intervention in the field of education may be an exception. Forward-looking countries may and do subsidise the education of their labour and management. Retaliatory measures and sanctions for subsidies to education and training have not (yet) been invented and applied. The reason is that the effects of such subsidies are slow in coming and become apparent only in the long term.

3. There are also various issues with regard to the disintegration of countries, as experienced, for example, by the Soviet Union, Czechoslovakia, Yugoslavia or Ethiopia (Eritrea) in the early 1990s. In addition, there are strong, long-term and sometimes even violent regional autonomy (and more than that) movements in many countries, including France (Corsica), Spain (Catalonia and the Basque region), Britain (Northern Ireland, Scotland, even Wales), Belgium (the Flemish region), Italy (the northern ‘Padania’), Russia (Chechnya), Turkey and Iraq (Kurdistan) or Ukraine (eastern part).