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## Integration for development — Hopes and problems

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tem would result in no more than a slight improvement<sup>14</sup>. It would be a different matter if the Mediterranean scenario were enacted. Provided the Mediterranean bloc would not have to be viewed as an area of French or Italian dominance and if it aimed at a growth model fundamentally different from the model of the consumer society, it could in certain circumstances meet the demands of the developing countries in *this* region for a new international division of labour. This would not however extend to the other developing countries, e.g. those in Black Africa, Latin America or Asia.

Is the study of the French Ministry of Industry and Research of significance beyond the confines of the intra-French discussion? The answers

<sup>14</sup> Characteristic was the reaction of Samir Amin, a scientific delegate from the developing countries who represented their interest at the study conference of the Ministry of Industry and Research on April 28-29, 1976.

to the three previous questions have already shown this to be the case. Besides, the study has supplied a wealth of empirical material which could not have been collected without the participation of several research commissioning institutions in France or without drawing on data of the French Ministry of Industry and Research. The importance of the study is, finally, indicated by the recent launching of a major three-year research project on the development of the international division of labour by the OECD and by the fact that – as the last UNCTAD conference demonstrated – the UN cannot ignore any longer the demand for a new international economic order by the developing countries.

It is to be hoped that the consideration of alternative solutions will receive more attention and help to find a way out of a situation marked by lack of analytical capabilities, originality and political determination.

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### ***Regional Associations***

# Integration for Development – Hopes and Problems

by Dr Ekkehard Bechler, Hamburg \*

**The following article deals with the conditions under which regional associations in the Third World can improve the economic situation of the developing countries and the question how suitable they are for this purpose.**

It is certainly true that the origin of the various attempts at economic integration of developing countries can only be judged properly if the course of international trade relations since World War II is borne in mind. One of the salient features of the fifties in this respect was the growing dissatisfaction of the LDCs with a system of world trade which limited their role – often under the influence of the “pure” theory of foreign trade – to that of primary goods suppliers. It had become more and more obvious that the low income and price elasticities of the world demand for these products, in conjunction with the wide short-term fluctuations in export earnings, gave them no adequate basis for those capital goods imports without which their industrial development could not be speeded up or indeed started off.

This was the reason for the policies of internal diversification and import substitution by means

of high tariff barriers and, above all, restrictions on consumer goods imports in the fifties. In this way it was hoped to make room for more capital goods imports, but most of the countries which pursued a strategy of this kind had to realize sooner or later that higher capital goods imports actually aggravated their balance of payments problems, notwithstanding (or even because of) their efforts to replace imports. At the same time idle capacities and inefficient plants in the semi-finished and finished goods sectors showed the limited size of the LDC markets to be an additional hindrance to meaningful import-substituting industrialization the moment it spread from simple to more advanced products, and this problem was aggravated further by uneconomic multiplication of import-competing industries in adjacent countries.

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The suggestion that the problems of small-scale production and competitive disadvantages compared with the developed countries (DCs) should be tackled by regional associations of adjacent LDCs stemmed from this experience. It was thought that the advantages of specialization could thereby be linked with the gains from substitution of imports from DCs, and further that the collapse of the world market prices for the traditionally exported primary products could be arrested by strengthening the bargaining power of the LDCs. Pooling of national export earnings seemed to promise a solution also for the — often disastrous — fluctuations of the income from primary exports. A start was made in several areas with regional integration: the Latin America Free Trade Association (LAFTA), the Central American Common Market (CACM) and the East African Common Market (EACM) are among the best-known examples.

Opinions differ to this very day about the economic success of such integration efforts. To go by the traditional theory concerning customs unions it is indeed doubtful whether integration can be beneficial. The crucial issue in this traditional approach is whether the trade-creating effects outweigh the repercussions of the trade diversion which may result from the creation of an integration area. For if consequent upon the removal of trade barriers between the partners in an integration agreement the demand for a product is no longer satisfied by high-cost producers in one country but by more efficient and therefore lower-cost suppliers in a partner country, this restructuring helps to improve the factor allocation and constitutes a prosperity-promoting effect of the regional integration efforts. If tariff preferences for producers in partner countries have the opposite result of putting more efficient suppliers in non-member countries out of action, regional integration causes a trade diversion and thus a deviation from the optimal resource utilization.

#### **No Basis for A Priori Statements**

It follows that there is no basis for a priori statements about positive or negative effects of integration on prosperity. But one can attempt to specify the conditions in which trade-creating effects arise or predominate: the chances that such effects predominate are the greater the higher were the original tariff rates in the trade between the partner countries. Besides, prosperity-increasing effects may be expected whenever the initial production and consumption structures, though similar, indicate marked cost differentials, so that gains from specialization may be anticipated. A low common external tariff also improves

the chances for a prosperity-increasing effect of integration because potentially superior producers in third countries will in this case encounter minor trade obstacles only. Finally, the prospects are to be considered the more favourable the larger is the size of the integration area, i.e. the greater is the combined share of the associated countries in world trade and total international production. The reason for this assertion is obvious, considering that in the extreme case of an integration taking in all trading nations there would be none but trade-creating effects.

No clear picture however arises when these criteria are used for an assessment of regional integration efforts in LDCs! As far as the tariff rates are concerned, it may be assumed that high tariff barriers are the general rule between the partner countries and can be removed, but it is unlikely that the external tariff barriers will be readily lowered in the course of the integration process, for negotiations with a view to the integration of prospective partners are in most cases greatly helped and facilitated by a more protectionist policy towards the outside world. Such policies make it also easier to coordinate trade policy measures inside the integration area because it appears to benefit all partner countries equally.

The infant industry argument is very often adduced in this context as applying to the creation of larger regional markets and justifying protectionism against the outside world, especially in answer to remarks about the practical conflict between an integration policy and the GATT regulations: these stipulate that the common external tariff must not be higher than the previous tariff rates. But it is claimed that trespasses against this principle are justified by the hope for faster economic growth and subsequent tariff cuts.

#### **Limited Expectations for Beneficial Effects**

The importance of measures of tariff policy for foreign trade must not be overrated since high inflation rates and distorted exchange rates, while often seriously hampering intraregional trade, may in some circumstances mitigate or obviate the effects of a protectionist tariff policy on the trade with DCs. It must also be borne in mind that lack of suitable transport facilities between the partner countries may inhibit the creation of trade between them and the available transport routes were in many instances designed for the conveyance of traditional primary products to the industrialized nations. The practical questions involved in the execution of commercial transactions also have a bearing on the direction and structure of the trade between LDCs and hence

on possible trade-creating effects of integration efforts and must not be underestimated.

If the structure of production in the LDCs seems to create favourable conditions for integration, it must be said that appearances are deceptive! In many points there is in fact a similarity between the supply and consumption structures of most of the countries considering integration, and the existence of substantial cost differentials seems to speak in favour of specialization, but this does not on closer examination warrant conclusions about the potential for trade creation and specialization gains: reallocation gains are unlikely to accrue from possible substitution in the primary production structures because the bulk of the exported primary goods is intended for the manufacturing markets of the industrialized nations and there are no processing facilities in adjacent LDCs. The intraregional trade is for this reason mostly confined to complementary product exchanges and unlikely to receive an early stimulus from the integration efforts.

Integration may hold out slightly better prospects for manufactured goods and local foodstuffs. In these spheres the production structure generally indicates a potential for substitution due to real cost differences. Experience has however shown all too often that the individual countries are unwilling to discontinue inefficient high-cost productions and thereby surrender their economic "national independence" in order to expedite the creation of trade in these categories of products.

The chances for efficiency-promoting reallocation also look rather unpropitious as far as the size of the possible integration markets is concerned: in LAFTA the gross national product in 1967 was 12 p. c. of the figure for the USA, but in the CACM

it was only 0.5 p. c. and in the EACM no more than 0.3 p. c. Under this aspect the traditional integration theory also suggests that any gain from economic association between LDCs would at best be marginal. It is true however that even a small gain may in a relative sense be quite important for LDCs. Moreover, the gain does not depend solely on the given size of the union but on the rate at which it increases. In view of the interaction of the described factors it would nevertheless appear that the expectation of beneficial results from integration prompted by the conventional theory regarding customs unions must be qualified.

#### The Importance of Dynamic Integration Effects

A closer study reveals the existence of a number of special causal connections which must be taken into consideration in an assessment of integration efforts between LDCs but are not adequately covered by the theory on customs unions which forms part of the comparative-static "pure" foreign trade theory. For the problem of economizing resources within given structures of the economies may possibly not be as significant in the case of integration moves by LDCs as it is for the integration of economies at an advanced state of development on which the traditional textbook models are usually based. The main consideration for LDCs are the dynamic integration effects: on these do they base in the main their hopes for more rapid growth and industrialization.

It is crucially important for them that use is made of the internal and external economies of scale through which the inefficiency of import substitution strategies in too small national markets is to be overcome. Trade-diverting integration may prove to be entirely desirable under this aspect if

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it turns protectionist preferences for inefficient local suppliers into preferences for the most competent suppliers inside the integration area. The static losses in efficiency incurred in connection with the trade diversion are in this case to be regarded as a charge on the gains in growth which result from import substitution.

Seen in this light, regional integration of LDCs thus has mainly the function of reducing the cost of important substitution by use of opportunities for specialization inside the integration area and of economies of scale since the choice for most LDCs is not, at least not in the short run, between the static optimum of free trade and (as a second best) regional integration but between a mostly inefficient policy of national protection and regional protection and regional import substitution which involves smaller losses.

### **Limited Opportunities**

Over and above these economies of scale, dynamic integration gains are expected to arise from the stimulation of competition between suppliers in the individual partner countries which is to follow from the enlargement of the economic area. Such stimulation of competition will result in increased productivity and reallocation of resources to the most efficient suppliers in the particular industry. Resource availability may increase in some circumstances if more intensive competitive conditions result in greater willingness to adopt more modern means and methods of production.

There is no doubt however that these effects can only come about if the participating countries had already achieved a minimum of national industrialization at the start of the integration period and this industrialization had produced similar structures in the partner countries. If, on the contrary, the production of primary products still predominates, the competition between the suppliers will as a rule be oriented to the markets of the industrialized nations and will as a natural consequence not be directly affected by the integration. The situation will be similar if the production of semi-finished and finished goods is still at a rudimentary stage: the opportunities for elimination of high-cost producers through intensified competition at the regional level will be rather restricted.

The importance of economies of scale must also be judged differently if for lack of the necessary minimum of industrialization the efforts to increase the efficiency of import-substituting industries come up against limits created by supply bottlenecks for raw materials, other primary products and energy as well as the smallness of the market. An expansion of the market alone will not

always trigger off an acceleration of industrialization as hoped for if the production conditions are not improved at the same time.

One important aspect however remains in justification of a development-oriented integration policy, namely the hope that the creation of an integrated market sets in motion specialization tendencies and other changes in the structure of production and trade which allow the factor deployment to be oriented to the structural requirements of a growing market at an early stage already. This would happen in particular if the integration efforts were flanked by more or less centralized planning and coordination of complementary and substitutional investment projects. The expectation of an increased inflow of foreign direct investments also rests in many instances on such an increased transparency of the national development efforts and consequent opportunities for more efficient use of industrial plants.

### **Economic and Political Prerequisites**

A warning should be added however: care must be taken not to overestimate these influences, for the centralization or coordination of investment decisions has not only the mentioned advantages but may lessen the competitive pressure and contain the germ of monopolistic inefficiency if potential competitors are kept out or the directive price mechanism is put out of working order.

The economic integration of individual LDCs, no matter how far it goes, will sway the decisions of foreign investors only if the political stability of the integration area seems to be assured.

Steadfast and lasting support for the integration idea by the political authorities depends upon a number of important economic and political conditions. If these are not fulfilled, early endorsement of the integration may give way to second thoughts. It is after all not always easy for young LDCs where a conscious national spirit is only just burgeoning forth to relinquish rights of national sovereignty and economic autarchy. It is also difficult for political leadership groups to surrender such rights when they see the basis of their claim to national leadership threatened by an increasing need for institutional cooperation — a problem which is incidentally also a characteristic of integration moves other than between LDCs — and when the exclusive use of nationally available development aid ties seems to be in jeopardy.

Besides these political hindrances to integration there exist in many cases economic problems: it is for instance by no means certain that the possible advantages from economic union will

always bring equal benefits to all partner countries. The export opportunities of some countries mainly concern primary products whereas the manufacturing industry in the integration area may be concentrated in one or two countries. In this case there is a risk that economic growth and industrialization may be speeded in these latter countries alone while the primary products exporting countries will be reduced to the role of a market for the manufactures of their more highly industrialized partners. The non-industrialized partner countries will have the additional difficulty of losing customs revenues by this "import substitution on a regional basis". This is a further economic impediment to integration especially in LDCs.

Problems of the described kind have been a significant obstacle to integration in the Latin American free trade zone because of the development lead enjoyed by Brazil and Mexico. The Central American Common Market was more favourably placed in this respect. The economic growth of the relatively more industrialized partners may offer a prospect of increasing demands for agricultural produce and raw materials from the other partner countries which would alleviate these difficulties, but the fact that considerable political efforts will be needed to avoid a perpetuation of the leads and lags in development and industrialization in the region is beyond doubt: compensation payments, regional development banks or joint financing of infrastructure projects are means to this end.

It is important that the proclivity for integration should be fostered in this way, and one of the reasons for this is that the slow progress of the integration moves is giving rise to growing scepticism in the industrialized nations. It is a fact that while GATT regulations allow discriminatory tariff cuts on a regional basis if there exists a binding timetable for the complete removal of tariffs and the protectionist effect on non-members is not intensified, these particular conditions have not been adequately met for most LDC integration schemes. This is shown by LAFTA and CACM in particular.

#### **Long-term Prospects**

An assessment of the importance of regional integration efforts in the Third World for development policy would be incomplete if it focused on the short- and medium-term prospects only. In this respect the reallocation gains of the static model are admittedly a less important yardstick of success than the dynamic gains in efficiency resulting from the enlargement of the economic area, but on a closer examination it cannot be ruled out that these latter gains are also non-recurrent

increases in productivity and growth which operate only during the market expansion phase. For the more clearly it is seen that the larger domestic markets created by regional associations cannot start off a lasting growth process on a basis of regional import substitution, the more evident it also becomes that growth acceleration over a longer term which is imperative for the eventual reduction of the international development differentials can ultimately be achieved only through LDC participation in the expanding markets of the industrialized countries.

The Central American integration area which is in a relatively advanced state of development clearly confirms these misgivings: following a period marked by rapid expansion of intraregional trade and fast growth of the gross national product and industrial production between 1960 and 1965 there has been increasing evidence since the middle sixties that the forces making for growth are weakening and the balance of payments problems are again worsening in consequence of a rise in the imports of capital goods and industrial semi-manufactures.

#### **Regional Integration No Panacea**

This confirms the impression that if the integration is conceived with the sole aim of enlarging the home market and offering more scope for import substitution, it does not commend itself as a means of promoting long-term development. Only if "extended import substitution" is understood as a means of preparing the LDCs for entry into the world market and bringing an influence to bear on the future production structure can it prove itself really suitable as an instrument with which to promote development. This explains why those production sectors should be encouraged which are, on the one hand, only viable in larger markets and, on the other, expanding on a global scale.

It would be utopian to regard the attempts at regional integration as a panacea or to expect the LDCs to shoulder these development tasks by themselves. International financial aid will remain indispensable since the gains to be derived from integration in the short term will – if they materialize at all – usually be small and unevenly distributed and the requisite structural changes are bound to impose such heavy economic burdens on the countries concerned as to put at risk the political will to engage in integration projects even though they make sense and promise long-term success. Technology transfers and access to the markets of the industrialized nations will not be obviated either by these integration efforts. They are indeed likely to prove a necessary complement to the development efforts of the Third World countries themselves.