Economic Theory and Regional Economic Integration of Asia

HIROSHI KITAMURA*

The problems and prospects of regional economic cooperation or integration in Asia are today a hotly debated subject, discussed at very different levels in different quarters. In an ECAFE paper entitled "The Scope for Regional Economic Cooperation in Asia and the Far East",[1] the view was advanced that cooperation implying coordination of economic policy as a whole is already on Asia's agenda of practical politics. After the economic rationale of cooperation in varied forms had been considered in a general way, an appeal was directed to policy-makers in the Asian region to establish a suitable framework for cooperation within which concrete blueprints of cooperative schemes could be worked out. It is significant that, at the Conference of Asian Economic Planners which discussed that paper among others, there was no disagreement in principle about the need for increased economic cooperation among the countries in Asia and the Far East. There was disagreement only as to what extent of cooperation in relation to the time perspective and what practical forms of it were most desirable—matters concerning which the Conference was by its nature prevented from making a decision and into which further exploration could be made through intergovernmental consultation.

The present paper is concerned primarily with the relevance of economic theory to the problems of regional economic cooperation and integration in Asia. Theory is not able to settle disagreements motivated by practical interests or by non-economic and political factors. However, it can at least shed some light on what should be expected as a consequence of a certain action or non-action and pave the way towards reaching desirable decisions by clearing away some misconceptions and making the implications of such decisions explicit.

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*Professor Kitamura is Chief, Economic Development Branch, United Nations Economic Commission for Asia and the Far East, Bangkok, Thailand. The present paper is written by the author in his personal capacity, and the views expressed therein are not necessarily those of the United Nations Economic Commission for Asia and the Far East.

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SECTION I: CONCEPT OF ECONOMIC INTEGRATION

The discussions in this paper are focussed on the concept of integration as the goal of rational economic policy, as distinct from the rather elusive concept of cooperation. It may be useful at the outset to make clear the idea underlying the choice of concept. Cooperation between independent nation States may include a wide range of actions relating to technically welldefined fields, such as patent laws or communication; some of these cooperative actions may be of economic importance but must be relegated to the secondary place in a discussion of economic policy. Some international consultations in matters relating to economic policy, such as agreements on trade policy at a forum of General Agreement on Tariffs and Trade (GATT) or at International Monetary Fund (IMF) consultations, are examples of international economic cooperation which, however, do not fall under the purview of the present paper. The main point is not their worldwide character, but that they do not contain elements pointing to the creation of a new and desirable institutional framework.

On the other hand, when its objective is institutional, cooperation can be a stage in the process of integration. The trade consultations carried out under the aegis of the Organization for European Economic Cooperation (OEEC) were clearly a case in point. The participation of the United States and Canada in the newly created Organization for Economic Cooperation and Development (OECD) can also be interpreted as a first step towards an economic integration in what may be called the Atlantic Community. Insofar as integration is considered a process, some forms of international cooperation can be seen as lower stages of integration.

That the concept of economic integration has been chosen as the frame of reference in this paper means, therefore, that the start is made from the institutional goal which can be defined with Professor Tinbergen as "the creation of the most desirable structure of international economy, removing artificial hindrances to the optimal operation and introducing deliberately all desirable elements of coordination and unification."[2] Our platform having been thus established, it follows that the problem of economic integration is part of a more general problem, namely, that of how to formulate and implement the optimum economic policy. Not every form of cooperation is necessarily conducive to the optimization of economic performance. Although the concept of integration itself implies the desirability of a certain degree of unification—and there is a school of thought that maintains that integration means an equal opportunity for all parts—the approach suggested here can be rather selective and flexible: a full unification is not advocated for all cases.

2. J. Tinbergen, *International Economic Integration*, (Amsterdam: Elsevier, 1954), p. 95.

It is sometimes suggested that economic integration would pass through three different stages, namely, cooperation, coordination and full integration, the one leading progressively to the other in accordance with the extent to which national sovereignty is surrendered. It is also often implied that a higher form of integration should be a more efficient one from the policy point of view. So far as the process of economic integration is concerned, however, the surrender of national sovereignty is only one of the means to achieve the goal and may not be as important as other means.

The relative importance to be given to the removal of barriers to movements of commodities and factors of production may also differ from case to case. This relativist approach is in conflict with the point of view of economic liberalism. According to the latter, economic integration is identified with the successive steps of liberalization of trade as well as factor movements, and the need for harmonization or coordination of economic policy as a whole will emerge only after a full liberalization of commodity and factor movements has been achieved in the form of a common market. In other words, the coordination of policy is something which characterizes only the higher forms of integration, namely, economic union or total economic integration.

In the present-day economy, however, where the extent of government intervention in economic life for various policy objectives has been considerably increased, the purely negative action of trade liberalization may not go far in achieving the desirable degree of integration unless accompanied by complementary measures of a more positive nature. It is probable that the attempt to coordinate and harmonize national economic policies will be an important instrument even in the earlier stages of the integration process. In certain circumstances, in fact, integration may be accomplished to a considerable extent without lifting the existing trade barriers; in that case, trade liberalization will follow to give effect to the harmonization of national economic policies. This consideration is particularly relevant to the issue of economic integration, insofar as it arises in the context of underdeveloped areas.

Economic integration is, thus, a process in which an attempt is made to create a desirable institutional framework for the optimization of economic policy as a whole. Many forms of international cooperation will be excluded from the discussion in the present paper because they do not aim at the institutional goal and because they are not related to the central problems of economic policy. On the other hand, the concept of economic integration is broad and flexible enough to cover an extremely varied range of cooperative actions. For instance, integration can start with some decisions limited to a partial field of economic activity. Then, we have integration by sector, as exemplified by a commodity common market in the form of the European Coal and Steel Community. Conditioned by the close interdependence which exists between various sectors of the economy, the emerging disequilibria will inevitably bring home to the countries concerned the need for, and the benefit to be expected from, a closer integration in a wider field.

To start from the goal of economic integration is not to say that the regulations of current-trade transactions are not important for the process of integration. The expediting of the current-trade relations undoubtedly contributes to the strengthening of mutual understanding and confidence which, in turn, creates conditions favourable for further steps towards economic integration. Once a form of international integration is established, there will always be an immanent tendency to move into a higher form of integration. Suppose that a free-trade area is created. Since the tariff rates of individual countries *vis-a-vis* the outside world are maintained at different levels, the need to control re-exports from one member country to others will inevitably move the scheme in the direction of a customs union. Once a common tariff is established, the need to liberalize factor movements will suggest itself in order to secure the most efficient allocation of resources within the framework of a common market. At this advanced stage, however, a certain degree of coordination of fiscal, monetary and wage policies will be a necessary ingredient of the integration policy and point to the establishment of an economic union.

It can be argued, therefore, that it does not greatly matter at what point and in what field of economic activity an integration movement is initiated. This is also the basic reason why our frame of reference has been deliberately chosen in flexible and relativist terms.

SECTION II: STRUCTURAL CHARACTERISTICS OF TRADE AND DEVELOPMENT IN ASIA

To discuss the relevance of economic theory to the problems of regional economic integration in Asia, it is necessary to have at least rough ideas about the structural relationships prevailing in the Asian economy, especially with regard to trade and economic development. The following sketch of the structural characteristics does not aim at establishing a strictly quantitative model of the Asian economy nor claim to be exhaustive. Reduced to the most essential of the relationships between trade and economic development, the economy of the Asian region may be said to be characterized as follows:[8]

[8] The Asian region in this context should be understood to denote mainly the underdeveloped areas of non-Communist Asia, that is Asia except for Japan and Mainland China.

1. In terms of national income per head, Asia is the worst-off area in the world. Not only is the present income level low, but much of the low rate of income growth has been absorbed by the growth of population. Achieving an accelerated rate of economic growth is today the absolute postulate of economic planning universally adopted by the countries in the region.

2. The bulk of the region's exports, namely, 80 per cent for the region as a whole, consists of primary products. The reliance on primary exports has shown no significant change in the post-War period; the diversification of the economy through industrialization is just beginning to affect the export structure. On the side of imports, manufactured goods predominate. Although the imports of consumer goods still remain at a relatively high level, the share of capital goods in the total imports has tended to increase significantly in recent times. At present, about a half of the total imports is in the form of capital goods.

3. Imports have tended to grow faster than exports. The overall balance-of-trade position of the region has definitely changed from an export surplus in the pre-War time into a chronic import surplus in the post-War period. The cessation of the private capital flow, which was an important offsetting factor before the War, has brought the region's balance of payments into continuous deficits, which have mainly been covered by foreign assistance and by drawing upon reserves.

4. The expansion of the region's exports has been disappointingly slow, not only slower than the growth of the region's income, which in turn has been slower than that of the world's product, but also slower than the growth of the world's exports, and slower even than the growth of exports from other underdeveloped areas. As the inflow of foreign long-term capital accounts for only about 5—10 per cent of the total foreign exchange receipts of the region, the trend of growth in the capacity to import is largely determined by the region's export earnings. The region's dependence on advanced industrial countries for exports is high. An analysis shows that, in the long run, the region's capacity to import is mainly determined by changes in the export volume rather than by changes in the terms of trade, the latter being influenced mainly by changes in export prices. This means that the demand situation in the industrialized countries exerts a decisive influence on the import capacity of the underdeveloped countries in Asia.

5. Insofar as the region's foreign trade is related to its income, the degree of the region's dependence on foreign trade is still relatively high, but it has tended to decline in the post-War period, especially with respect

to the region's exports. It is noteworthy that, notwithstanding the tendency for the capital-components of the imports to increase at a faster rate than national product, the rate of growth of total imports has not been higher than the rate of income growth in most countries of the region. This is the measure of the extent to which the policy of import-substitution has been actually effected in the region. Its effect on the reduction of consumer-goods imports has tended to be offset by an increase in the import demand for producer goods, and the total import coefficients have not declined appreciably, except in the countries with large national markets.

6. The main link that exists between imports and domestic income growth of the region is the fact that the import trade is, under present conditions, the principal means of securing the supply of capital goods. In general, the import-content of domestic fixed capital formation of the region has not changed significantly. The ratio of capital-goods imports to domestic investment expenditure is now in the range of 25—50 per cent in most countries in Asia, and the share of capital goods in total imports tends to be twice as high as the ratio of investment to total effective demand. In almost all countries in Asia, the rate of increase in capital-goods imports is very much higher than the rate of growth in industrial production and national product as a whole.

7. The extent to which imports of capital goods can possibly be substituted for imports of consumer goods depends upon many factors, including the relationships between domestic demand and production, not only in the investment sector but also in other sectors. It can be statistically maintained that, while the import-inducing effect of capital investment is very considerable, the marginal import coefficient of consumption is generally low. Where the rate of increase in the capacity to import in the last decade exceeded the rate of growth of domestic consumption, it was rather easy to raise the supply of imported capital goods and yet to maintain the import-content of consumption as in India, or even to raise it as in Burma. Where the capacity to import increased more slowly than domestic consumption, as in Ceylon or the Philippines, the share of capital goods in total imports could be raised only by deliberate import-substitution in consumer goods.

8. However, typically for the Asian region, the rate of growth in domestic capital formation has tended to surpass the rate of increase in the capacity to import. In view of the limited effectiveness of import-substitution in affecting the supply of foreign exchange for capital-good imports, the rate of increase in the capacity to import has been the major factor limiting the rate of growth in domestic investment, and thus the rate of economic growth itself.

9. As for the geographical composition of Asia's trade, the trend in the post-War period has been that the share of industrial countries in the region's exports has declined, whereas it has increased in the region's imports. At present, about one-third of the region's foreign trade, including Japan's, is intra-regional, about one-fourth is with Western Europe, and about one-fifth is with the United States. On this statistical evidence, it is often maintained that the share of intra-regional trade is relatively high in Asia, as compared with other underdeveloped areas. However, a close examination shows that the main part, probably 60—70 per cent, of this intra-regional trade is accounted for by entrepot transactions through Hong Kong and Singapore. Therefore, the real trade network among the countries of the region would not appear to amount to very much more than 10 per cent of the region's total trade. Asia's trade structure does not show a greater degree of mutual complementarity than, for instance, that of Latin America.

10. All the trade relations analysed here are presently subjected to a severe regime of exchange and import control. Considering the prevailing disequilibria and the pressing postulate of economic growth, it is easy to understand why such control measures are maintained and why resort is being made to a deliberate policy of import-substitution. To the extent to which industrialization through import-substitution has taken place, however, the countries in the region have tended to discriminate against imports from within the region, in view of the necessity of securing the supply of capital goods from the rest of the world.

SECTION III: CRITERIA FOR EVALUATION

The issue of economic integration at a regional level involves a choice between alternative long-run institutional arrangements in the relations of a country to the rest of the world. In the Asian region, we have to consider a typical underdeveloped economy whose rate of growth is, as stated in Section II, limited by the stagnating export-based capacity to import. Disequilibria, structural in the sense that underemployment and underutilization of domestic resources are combined with external deficits, are one of the common features of the economies in the region. The price and market mechanism cannot, therefore, work out an optimum solution smoothly. If economic growth is to be accelerated beyond the limit set by the rate of export growth, planning has to aim at promoting domestic production through some kind of deliberate import-substitution policy. But such a policy, formulated on the basis of narrow national market, will inevitably bring about a loss in efficiency and be subject to the limits of economic and technical expediency. Not only will the rate of economic growth be reduced below the maximum attainable level, but the economy will be increasingly exposed to a new kind of external vulnerability, thus narrowing down the room for planning decisions. To avoid this pitfall of the import-substitution policy, the only way out will be to conceive a policy in broader and more rational terms, namely, in the context of regional economic integration This is in essence the basic argument developed in Section IV of the ECAFE. paper.[4]

The pertinent question is, therefore, what institutional framework of international relations is most conducive to accelerating the economic growth of each country taken separately as well as of the region as a whole. The particular way, however, in which the problem is formulated poses a series of questions which have to be clarified in advance.

First of all, the objective function to be optimized is economic growth, or rate of growth. Now, the choice of the growth function will depend upon the nature of the problems at hand. In our context of trade and development, the accepted view will be that economic growth is a function of real capital formation in which the effective supply of capital and investment goods plays a cardinal role, provided that a sufficient capacity to absorb capital exists in the domestic economy. Insofar as most of these capital and investment goods are imported from abroad, as is the case with a typical underdeveloped country in Asia, the rate of real capital formation is conditioned by the capacity to import, which is either based on the country's export earnings, or created by foreign capital inflow, and by the possibility of substituting capital goods for consumer goods in total imports. Given the capital flow and the composition of imports, therefore, it can be said that the country's growth potentials will be exploited to the optimal extent, if the country's export base can be expanded to the maximum without disrupting production for domestic demand. To the extent that savings can be incorporated in capital goods domestically produced, it will be necessary to take into account the complementary structure of real capital, but the country's capacity to import will still remain the basic determinant for the degree to which its growth potentialities are actually realized.

However, the influence of the choice made between alternative economic environments will not be confined to its effects on export earnings and capacity to import. The magnitude and direction of productive investment will also be directly affected by the change in the size of potential markets implied in the making of this choice. The expansion of potential markets may, for example, bring about increased opportunities for profitable activity of foreign and domestic investors. It is true that investment is not so sensitive to a given inducement in a typical underdeveloped economy

4. ECAFE, "The Scope for Regional Economic Cooperation in Asia and the Far East," *op. cit.*

as in an industrially advanced one, but these effects of the market demand on investment activity should not be neglected altogether. In the long run, the changed nature of investment will have a greater influence on the future pattern of output than the shift in the present trade-pattern.

If a given choice of institutional framework of economic policy should help the country concerned towards achieving a balance-of-payment equilibrium, this beneficial effect could be considered a side condition for optimizing the rate of economic growth. However, the present gap in the balance of payments in a typical underdeveloped country is in general a reflection, not simply of monetary and price imbalances, but more fundamentally of the real forces creating an increasing gap between the import requirements and the stagnant capacity to import. The existing disequilibrium does not only make it impossible for a country to achieve the desirable rate of growth on a balanced basis, but calls for an increasing degree of exchange controls and trade restrictions which, as stated under No. 10 in Section II, tend to discriminate against other underdeveloped countries in the region.

This consideration is of particular importance for any discussion of regional economic integration in the underdeveloped areas of Asia at the present time. We do not start with an overall equilibrium and a universal free trade. For, the present international environment does not seem to allow a typical underdeveloped country to grow satisfactorily under the unrestricted play of action and interaction of the market forces. On the contrary, the tendency will inevitably be towards a further distortion of the price structure and the patterns of production and trade. On the side of production, the country will be forced more and more to direct investment into production for the domestic market at whatever cost in substitution for imports. This severely limits the relevance for the analysis of our present problem of the traditional economic theory, which is based on the static assumptions of equilibrium and perfect competition. It will not make much sense to discuss the consequences of regional economic integration in Asia in the light of a hypothetical situation of a balanced and free trade. Rather, they must be considered, not only against the alternative of the existing disequilibrium, but also against the alternative of what is likely to emerge in the absence of such an integration, if the present trends towards international and domestic disequilibria should be permitted to persist.

If we admit of the existence of disequilibria and still want to remain in the realm of a static equilibrium theory, it is appropriate to characterize the problem of regional economic integration as a case of "second-best optimum" solution. Now, the general theory of second best tells us that, "given that one of the Paretian optimum conditions cannot be fulfilled, then an optimum situation can be achieved only by departing from all the other Paretian condition."[5] To attempt to test the consequences of a regional economic integration against the optimum criteria of free trade is not very meaningful. Even a limited move towards the ideal of free trade does not necessarily represent an approach in the direction of the second-best optimum. Insofar as the choice is between two non-optimum situations, there is no *a priori* principle on which to decide which one is preferable. This conclusion, although logically correct, may appear too restrictionist at a level which is a little removed from purely *a priori* reasonings. Especially where deviations from the optimum conditions in a definite direction are implied, it must be possible for a theory, when reinterpreted in a dynamic context, to say something about the order of preference.

This is the case with our problem of regional economic integration. The distortion in the trade-pattern of a typical underdeveloped country tends to be more at the expense of specialization among neighbouring countries of the same region. If a reversal of this tendency should prove helpful in optimizing the country's or the region's rate of economic growth through maximizing the supply of foreign exchange for capital goods, then it would appear that there is presumption in favour of an institutional arrangement such as regional integration. In this dynamic context, a certain element of irreversibility is introduced into the system of interdependence between economic variables, and this is the reason why a theoretical solution can escape in some way from the purely negative character of the static theory as applied to the second-best optimum.

SECTION IV: GAINS FROM REGIONAL ECONOMIC INTEGRATION

Applying the criteria established in the preceding section, an attempt will be made in the present section to identify the economic gains to be expected from a scheme of regional economic integration. Something will be said also about the relative importance of various consequences of integration, but the statements that are possible at this stage will, for the most part, be based on circumstantial judgment. In the Asian region, no concrete scheme of regional economic integration has been worked out as yet, and even when a concrete scheme is given, an appraisal in quantitative terms of the consequences of the change in institutional arrangements is extremely difficult, if not absolutely impossible.

Insofar as the rate of economic growth is chosen as the final criterion for evaluation of gains, it may be well to note at the outset that the process of economic growth possesses multiple dimensions and that it is of a cumul-

5. R. G. Lipsey and K. Lancaster, "The General Theory of Second Best," *Review of Economic Studies*, No. 63, 1956-57, p. 11.

ative nature. The process cannot be decisively remodelled by once-for-all measures, such as changes in international institutional arrangements. Economic growth also necessitates, and is accompanied by, a continuous change in the structure of production and trade, and this latter is a process of quite a different dimension from, for example, a removal of trade barriers which can be effected at one stroke. An attempt at regional economic integration is, therefore, most unlikely to change immediately the basic determinants of economic growth. But it may create certain conditions of accelerated growth in the long run by eliminating some bottlenecks limiting economic expansion. And I would like to maintain that, since the international environment to be chosen is not of a transitional character, this long-run effect may be quite important.

Regional economic integration implies a broadening of the regional market and a reduction in the country's or the region's dependence on trade with the outside world, at least in relative terms, that is, as compared with the situation that is likely to prevail in the absence of integration. Where the tendency in the import-substitution policy has been towards discrimination against imports from within the region, this tendency will be reversed so as to increase relatively the volume of imports from, and of exports to, the regional markets. As a consequence, not only the pattern and volume of trade, but also the total volume and pattern of investment will change.

The main link between trade and development here comes into play. In the case of a typical underdeveloped country in Asia, which relies mainly on industrially advanced countries outside the region for the supply of capital goods, the reduction of its dependence on trade with the outside world is likely to take place in the field of consumer goods and other commodities which can be produced in underdeveloped areas with relative ease. Because of the broadened market in the region, these commodities can now be imported in a greater quantity from other countries in the region, instead of from the outside world. Through this intercountry substitution, the availability of the foreign exchange required for imports of essential development goods from the outside world is increased. Therefore, assuming that the bulk of real capital goods originates from countries outside the region, the supply of real capital goods and the magnitude of investment can be considerably increased by regional economic integration.

Such an increase in the capacity to import capital goods from the outside world could, of course, be achieved also through intercommodity substitution in imports. If a typical underdeveloped country is to grow on the basis of a rather slow growth of export earnings, and if there is no broadened regional market, the import-substitution policy will have to be aimed at the maximum degree of selfsufficiency at whatever cost in commodities whose imports can, by any means, be replaced. Such a policy will result in a reduction in the ratio of foreign trade to the country's domestic expenditure, entailing a sacrifice of the gains from specialization. However the creation of a broadened regional market can permit a country to achieve a desirable rate of economic growth without incurring a proportional loss in this respect.

The establishment of a more rational pattern of trade and production is, therefore, the most important justification for regional economic integration. There seems little doubt that a pattern of production based on greater specialization within the region will be more economical than one directed towards the maximum selfsufficiency on the basis of narrow national markets. If such a pattern of production and investment maximizes the supply of capital goods without disrupting production for domestic demand, as is the case with a typical underdeveloped country, it is at the same time most conducive to economic growth from the dynamic point of view. It is true from the standpoint of a static theory that regional economic integration will not establish the allround optimum relations between prices of domestic and internationally traded goods, but the situation can be legitimately called the second-best solution, insofar as the relative price and production patterns, even in a limited sphere, are shifted towards optimum conditions through intra-regional specialization.

There is, thus, presumption that economic gains will be secured if there is a net expansion of trade, the tendency towards declining overall ratio of foreign trade to national expenditure being more than offset by the increase in intra-regional trade. The question for the development policy is only how to direct the increased flow of resources into investment by increasing and maximizing the supply of capital goods. From this dynamic point of view, therefore, intercommodity substitution must be considered together with intercountry substitution with which the theory of customs union is mainly concerned. In certain cases, the goal of maximization of the supply of foreign exchange for capital-goods imports from the outside world may come into conflict with the expansion of intra-regional trade. In such cases, it is clear from the point of view of development policy that the objective of trade creation within the region, part of which may be trade diversion in the terminology of theory of customs union, should not be pushed forward beyond the optimum limit.

In general, it is easy to exaggerate the advantage of free trade and, for that matter, of international division of labour and specialization. Foreign trade is in most cases marginal to the total circular flow of goods in the economy, and a change in institutional barriers to trade such as tariffs and quantitative restrictions affects only a small part of the trade flow. However, some part of the goods secured through trade channels may be qualitatively very important, and the trade policy designed under a given development strategy will have to be highly selective. This selectiveness is important not only in respect of substitution between commodities, but also in respect of intercountry substitution. That is why the problem of regional economic integration becomes an important issue in trade policy for economic development.

The static theory of customs union does not seem to give adequate answers to this vital problem. Its analysis is usually confined to welfare gains and losses arising from varying degrees of specialization as a result of shifts in the existing trade patterns. Some attention has been paid to gains connected with economies of scale and changes in terms of trade, but the effects of a customs union on the level of aggregate economic activity or on the rate of economic growth have hardly been touched upon. Although some important insights into the mechanism of intercountry substitution have been gained, the relevance of such a theory to the problem of regional economic integration seems to be severely limited.

This limitation applies also to the main realm of the theory—to the analysis of welfare gains from specialization. As is natural in a static analysis, the main pillar of the traditional theory is the distinction between the trade-creating and trade-diverting effects of a customs union. It was originally considered that trade creation was beneficial to a country's and to the world's welfare, whereas trade diversion would bring about a loss to world welfare. However, it has been established in the course of further development of the theory that this simple distinction is an inadequate criterion for judging the effects of a customs union. If the effects on consumption are considered in addition to the production effects, it is no more correct to say that trade diversion is bad in all cases.[6] Even when a regional integration has only trade-diverting effects, that is, when trade is diverted from lower- to higher-cost sources of supply, a country as well as the world as a whole may gain from such a market arrangement.

In the case of a typical underdeveloped country, it is safe to assume that a regional economic integration will always result in a primary net expansion of trade. The secondary effects are, of course, much more complex. As a consequence of reduced demand for products of the outside world, the terms of trade are likely to turn in favour of the country concerned, as compared with the preintegration conditions of tariff protection. The extent of this favourable trend will depend on the bargaining power of the

6. *See*, R. G. Lipsey, "The Theory of Customs Union: Trade Diversion and Welfare," *Economica* (New Series), February 1957, p. 41.

country and the region as a whole, which will tend to be strengthened *vis-a-vis* the outside world by the creation of a regional market. Moreover, such an expansion of trade will not fail to exert considerable influence on the process of income creation, the gains with respect to which will go far beyond the realm of purely static trade gains. So far as trade with the outside world is concerned, the income effects will clearly tend to increase considerably the scope for beneficial exchange of goods with third countries, and this secondary trade expansion may very well more than offset the possible initial reduction of this particular type of trade. After all, the main objective of the integration move is the optimization of the supply of foreign exchange for capital-goods imports from the outside world, and there are fairly good grounds for assurance that the overall volume of trade will rather be increased, although its composition will be changed.

One might be inclined to say that a regional economic integration of underdeveloped areas will, in the long run, result only in the creation of trade, and that there will be no overall trade diversion. I prefer to stick to the original meaning of the concept and to say that there certainly is, and must be, a trade-diverting effect. This is one of the essential characteristics of regional economic integration. After all, what sense is there in conceiving a regional economic integration without a degree of discrimination against the third countries? Discrimination belongs to the nature of all tariffs and quantitative restrictions prevailing in the world economy of today. To be effective in countering the prevailing discrimination, regional integration must also partake of a discriminatory character and, especially in underdeveloped regions, the margin of preference must be extensive enough to promote economic growth through creating a broadened regional market. In the light of these considerations, trade diversion appears as an essential ingredient of the integration policy and not as a negative, but rather as a positive, factor in the evaluation of regional economic integration.

There have been some attempts to appraise the static welfare gains from a shift of the existing trade-pattern in quantitative terms. Such a shift will certainly involve a reallocation of productive resources and consumption, but the calculation has invariably shown that the economic gains from a greater degree of specialization, conceived in static terms, will not be very considerable. Such a conclusion seems inevitable, so long as welfare gains are identified with the differences between marginal social costs of imported goods and their substitutes produced domestically, which are reflected in the changes in tariffs. Even where the change in the volume of trade is considerable, the tariff changes to be chosen as the base of welfare calculation will tend to minimize gains. However, the main part of the effects of a change in the institutional market arrangement may be absorbed by interfirm and intersectoral reallocation of resources within the same country rather than reflected in a change in trade. Even in the short run, the process of such a reallocation may affect very significantly the level of productivity. Over a longer period, the productivity effects of a regional economic integration will be felt more strongly through a change in the nature, direction and volume of investment.

There is reason to assume that the immediate effects of regional economic integration on the efficiency of the country's economic organization will be negligible. However, a change in economic environment in the direction of the broadening of regional markets will, in the long run, affect investment, particularly in those fields where considerable economies of scale remain to be exploited. These productivity gains are additional to the dynamic benefits to be derived from the increased volume of productive investment made possible by the increased supply of capital goods through imports. The effects of a regional economic integration may, therefore, be the greatest on certain types of industries yet to be created or greatly to be expanded in the region. The productive process in such industries is usually characterized by a high degree of capital intensity, a long gestation period and large economies of scale, and their products are faced with a demand which is highly growth-elastic. In other words, a broadened regional market may open up quite a new dimension in the prospects of industrialization to a typical underdeveloped country in Asia.

SECTION V: FORMS AND METHODS OF REGIONAL ECONOMIC INTEGRATION

Our analysis of the economic gains to be expected from regional economic integration for a typical underdeveloped country in Asia seems to provide at least one important pointer for a practical approach to the problem: it should not be through a removal of trade barriers only or mainly through such a measure that economic integration of an underdeveloped region is to be organized. Apart from the insignificant nature of trade gains, the existing pattern of production and trade in the region is not such that the mere lifting of mutual trade barriers would considerably increase the trade volume. The reallocational effects of trade liberalization may be important in industrially developed regions, such as Western Europe, but in Asia the price and market mechanism is not expected to work efficiently enough to effect a radical change in allocation of resources in a more rational direction. The pattern of resource utilization is also subjected in this region to a greater degree of government intervention than elsewhere. In Asia, planning is the main instrument in the development policy, and the objective of accelerating economic growth can only be realized within the framework of planning, to which trade liberalization must be clearly subordinated.

A mutual agreement among the countries of the region to lower the hindrances to intra-regional trade, on a preferential basis, may constitute an important step and means for the realization of regional economic integration. But, in all probability, the beneficial effects of a free-trade area or a comon market in the Asian region will be rather limited. The basic reason is that the structural changes of the country's economy necessary for achieving an accelerated rate of growth would not be brought about automatically by liberalization of trade. To achieve the principal goal, mutual cooperation among the countries of the region will have rather to be extended to the sphere of production, with a view to changing the composition and magnitude of investment. This means that the purely negative action of removing existing trade barriers is not enough. Something more positive is required.

I suspect that the type of cooperative action which is urgently required in the region will be what is usually called coordination or harmonization of economic policies. Even in the context of an industrially advanced region, it is often argued with respect to agricultural products that it does not make sense to make trade free without measures aiming at readjustments of production. In this particular field of production, some action to coordinate and harmonize national production programmes is today virtually accepted as a prerequisite to the removal of trade restrictions. The same applies with a greater justification to the economies of underdeveloped regions in general, where the State intervention is needed to counter distortion arising from structural disequilibria. In these circumstances, there is weighty reason to assume that an optimal allocation of resources would not automatically come about under a regime of free trade. Hence, the need for a certain degree of harmonization of economic policies relating to allocation of resources. But, on the other hand, it should be clearly recognized that such coordination can pave the way to expansion of trade. The market can be expanded not by liberalizing but rather by organizing.

Such an organization of regional markets will inevitably be on a basis of regional preference. For, the problem of a regional market has today become a pressing issue of trade policy exactly because an integrated world economy has patently failed to come into being since the disintegration of the 1930s and the War period. Inasmuch as the expansion of government controls over the economic life of nations has increased the scope and the need for negotiated, rather than spontaneous, policy harmonization among politically independent countries, it has become clear that such a harmonization cannot be negotiated on a worldwide scale. Not only would a worldwide machinery be cumbersome and inefficient, but the political preconditions for the necessary adjustments in the exercise of national sovereignty are still lacking. There are also several reasons to suggest that greater potentialities exist for a more intimate form of coordination and harmonization of policy, through regional negotiations among highly interdependent countries which are well prepared for coordinated action by a common geographical and historical background and a relatively homogeneous stage of economic development.

The last point mentioned, namely cooperation and integration among countries at a relatively homogeneous stage of economic development, may deserve a little further exploration. According to the classical pattern of exchange between manufactured goods on the one hand and foodstuffs and raw materials on the other, it should have been more advantageous to organize cooperation among countries at different stages of economic development and with heterogeneous factor endowments. Why, then, does the unmistakable trend of the present-day world economy point to an increasing cooperation and integration among economies at a more or less similar stage of economic development? Reference has been made in the ECAFE paper to the historical fact that trade has tended to increase relatively among industrially advanced countries while relatively declining between industrialized countries and primary-producing underdeveloped countries. This remarkable trend may probably be connected with a certain change in the determinants of the trade-pattern; it is perhaps now differences in technology rather than differences in natural endowments which increasingly determine the patterns of specialization. Or, to put it differently, technical superiority, partly based on the advantage of economies of scale, is playing a more and more important part in determining relative cost differences between nations and is increasingly taking the place of the classical principle of factor endowments.

The above statement applies particularly to the comparative cost differences with regard to manufactured goods. For other categories of goods the conditions of relative factor endowments still remain the most important factor determining the location of production. But for manufactured goods, which are favoured by historical shifts in world demand, there is a large element of historical accident in decision as to where a particular type of production is to be located, especially where there is only a slight intercountry difference in relative endowments of capital and labour. Here, we have a new principle of international division of labour which is, to an increasing degree, replacing the classical principle of factor proportions (Heckscher-Ohlin theorem) in the present-day world economy.

Regional economic integration in our context is a case of trade cooperation among countries at a more or less similar stage of economic development. As the countries in the region are also at a comparable stage of capital accumulation, there cannot be much differences in factor endowment, so far as the relationship between capital and labour is concerned. It is clear, therefore, that the new principle of international specialization is one that should be appropriately applied to our case. One of the characteristics of this principle is instability in the pattern of division of labour. Since it is based on a variable relationship of technology which can be easily changed, with or without changes in factor combination, competition involves a large risk of rendering the established pattern of specialization extremely unstable. Some degree of mutual agreement is, therefore, required in order to derive economic benefits from specialization. On the other hand, the main basis of technical superiority is economies of scale, rather than advantages of location. Such economies can be realized more or less anywhere provided the market is broad enough to absorb the increased products. Therefore, agreed specialization is not only a necessary, but also a feasible, proposition. It should not be too difficult to locate joint industrial ventures so as to satisfy the demand of all the countries concerned.[7] Thus, the principle of agreed specialization will be an important and legitimate ingredient in any scheme of regional economic integration among underdeveloped countries.

The task of negotiated, rather than spontaneous, coordination and harmonization of economic policies will be enormously facilitated in the Asian region by the fact that almost all countries in the region have adopted the planning approach to the problem of economic development. Where there are already development plans incorporating more or less long-term policy directives, it is easier than otherwise for countries to confront one another with their plans and to bring about some mutual adjustments when certain inconsistencies are found. The only thing required is that eacn government should be prepared to submit its programmes to common scrutiny by a group of its fellow governments with a view to undertaking coordinated actions in the mutual interest of all the countries concerned. To illustrate how such a coordination can be worked out in practice, two examples from recent history are briefly examined below.

The first example is related to the recent movements towards coordinated economic planning in the East European bloc, where the idea of national planning had been predominant from the beginning.[8] The early history of unsuccessful operation during the initial period of the existence of the Council for Mutual Economic Assistance (Comecon) seems clearly to confirm our view that regional cooperation limited to trade would not go very

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7. A similar optimism about the prospects of agreed specialization is expressed in T. Scitovsky, *Economic Theory and Western European Integration*, (London : George Allen and Unwin, 1958), p. 51.

8. The basis for the following brief evaluation is mainly derived from O, Hoeffding "Recent Efforts Towards Coordinated Economic Planning in the Soviet Bloc" (mimeographed), (Washington : The Rand Corporation, 1959).

far if the spheres of production and investment were to be neglected. The original assumption was that the import requirements and export possibilities generated by independently drawn-up national economic plans of individual countries would somehow balance out in intra-bloc trade conducted under long-term agreements. This assumption did not prove justified. Since 1956 and 1957, therefore, the attention of Comecon was increasingly directed to the working out, by a series of technical committees, of concerted production and investment programmes in a considerable number of key industries, with emphasis on metals, chemicals, power and fuel. However, the task of "balancing" the sectoral programmes in a mutually consistent system of national development plans tied together by a network of long-term trade agreements did not prove to be easy to accomplish at one stroke. To avoid the difficulties of multinational "coordination of many details," resort has increasingly been made to bilateral negotiations and agreements among pairs of members, especially with a view to working out specialized and mutually dovetailed production programmes in various key industries.

For most of the East European countries, the objective of rapid industrialization on an inadequate resource-base fragmented by political barriers was posing an almost insoluble problem, and the only feasible solution was found in an attempt at regional integration based on the principle of "socialist division of labour." The lines of action now contemplated are to promote intra-regional cooperation in attacking the perennial basic materials and energy bottlenecks, and to organize industrial specialization along the most economical lines on the basis of mutual agreement, possibly introducing some measure of intra-regional mobility of capital through joint investment projects. One of the outstanding examples is the development of Poland's coal mining with the help of East German and Czech equipment credits. However, the correction of the distorted and uneconomic industrial structure created in the past by uncoordinated planning may prove to be more difficult. During the seven-year-plan period, 1958-65, the trade volume in the Comecon area is planned to increase by more than 60 per cent, while the rate of industrial output expansion is expected to be of the order of 70—80 per cent. Whether the development results in an increased integration of the bloc or not, this is a clear indication that the expansion of intra-regional trade is an objective secondary to the major goal of accelerated economic growth.

The second example refers to the experience of the Organization for European Economic Cooperation (OEEC) in its early period, which is more instructive for the Asian region than its later operations. The OEEC started as a permanent mechanism to formulate, and give effect to, a joint recovery programme of post-War Europe. New techniques of international cooperation were developed to ensure that the plans and policies of indivdual countries were compared and subjected to very close mutual scrutiny, that inconsistencies were removed as far as possible and conflicting targets harmonized into a "common planning" of Western Europe. In the process of examining the different national programmes, certain inconsistencies emerged, especially in the field of trade objectives. It is important to note that, as an OEEC report says, "the 'confrontation' of plans served to pinpoint the main problems and alert the different national authorities so that they could cooperate in their solution."[9] The continued process of policy coordination resulted in the Recovery Programme, 1948—1952/53, and in the 25-per-cent Expansion Programme, 1951—1956.

There is no doubt that these coordinated programmes considerably helped individual countries taken separately, as well as the European region as a whole, in quickly overcoming the post-War crisis and in embarking upon the process of accelerated economic growth. Under the regime of planned recovery, even the West European countries had to resort to major efforts towards coordination and harmonization of development and recovery policies. To some observers the essence of these operations was, according to the original intention, nothing but "a discriminatory common planning," although the OEEC mechanism was actually never used to plan for Europe.[10] The experience of OEEC in this period deserves, therefore, a close study by all who are concerned with the problem of economic integration in the Asian region, which has in general adopted the planned approach to economic development. In Western Europe at the time there was in the 1949 "Plan of Action" even a serious attempt at coordination of investment with a view to ensuring that investment projects should be developed rationally, avoiding inconsistencies and excess capacity.

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9. OEEC, *A Decade of Cooperation, Achievements and Perspectives*, (Paris: Organization for European Economic Cooperation, 1958. 9th report), p. 32.

10. T. Balogh, "Liberalization or Constructive Organization, or: The Hair of the Dog that Bit," *Bulletin of the Oxford University Institute of Statistics*, February 1957, p. 39.