CHAPTER 1

REGIONAL ECONOMIC INTEGRATION: Introductory Overview

After World War II, some countries raised, while other lowered trade barriers against their trading partners simultaneously and uniformly. Increasingly, the process of regional economic integration, or economic integration as it is commonly known, has attracted attention not only at the regional scale grouping but also at the world level for their own interests. Fundamentally, economic integration is defined as the elimination of economic frontiers between two or more economies; where countries join together to create a large economic unit with special relationship among the member.[1] Reduction or removal of tariffs and non-tariff barriers among the economies of a region will obviously promote economic integration within the region by facilitating the flow of goods, services, capital and labor. It is still questionable why regional economic integration command many countries' attention. There are many reasons behind this. Firstly, the most obvious reason is due to the success of the formation of the European Union on 1st January 1999. Consequently, the other regional groupings; not only ones with possibility to form an integration, but also the least possible ones, are trying to step-up to some certain level of regionalism or integration. Especially in East Asia, where the possible regionalism in East Asia is a highly controversial topic but there are still many obstacles behind this possibility. Secondly, the increased role of the World Trade Organization also mentions about the regional integration agreement - primarily custom union and free trade area. Additionally, the pace of globalization in the world economy has quickened considerably. Moreover, the world trade has increased drastically since the mid-1980 with more open economy and free trade arrangement. Consequently, many countries try to form an economic coalition in an attempt to obtain some benefits from more open economy. Some countries, especially the smaller countries, see this opportunity of trading agreement with larger partners as a way of obtaining more security for their access to larger country markets and more economic power. Some countries have tried to use regional agreements to protect against some possible subsequent reverse policies, which may have an adverse effect to their economies. Hence, Regional

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[1] Appleyard R. Dennis, Field J. Alfred, JR., "International Economics". Third Edition 1998, Davison College, University of North Carolina at Chapel Hill, p. 353.

trade arrangements around the world are thus different from one another due to their different objectives in the negotiations. Under this phenomenon, some countries fear that the creation of regional economic integration or trading blocs leading to greater protectionist tendencies. But principally, regional economic integration can either be a step towards global free trade which create many benefits and possible gains, or a move towards more protectionism or closed economy in the world which will most likely lead to some possible loss in the world economy. Many regional grouping are likely to join and form their own economic integration because they foresee the great benefits they may gain from this opportunity. The possible sources of economic gain from economic integration can be attributed to the enhancement of the production efficiency due to the increased specialization in accordance with comparative advantage and economies of scale. The economic integration will improve international bargaining position, which leads to better terms of trade and stimulate greater investment. Additionally, the unification efforts, in most cases, will lead to better employment level, lower inflation rates, balance trade, higher rates of economic growth an better income distribution[2]. By having the European experience as a good example, it is natural for other countries or regional groupings to look for guidance from Europe, and the more open their economy becomes, the more benefits are available to them. The European Union, by far the most successful economic integration effort, is the driving-force of other regional grouping to realize the benefits of the formation of economic integration and form their own ones. Obviously, the possible regional groupings, like North American Free Trade Area (NAFTA), Asia Pacific Economic Cooperation (APEC), Association of South East Asian Nations (ASEAN), and others, are attempting to deepen the level of integration with numerous reasons by using the European Union as their guideline. Integration, however, is an extremely complex process both economically and politically. Hence, it becomes more and more difficult to work out by following others footsteps. Why? The reasons are due to the diverse nature, characteristics and conditions of the different regions. APEC, for example, the participating members have a very diverse characteristics, political system, economy and geographical differences. However, applying some components of the success enjoyed by European Union to a particular regional economic integration can yield some benefit and jumpstart the integration process. The reason for the diverse effect

[2] Ali M. El-Agraa, "The European Union: History, Institutions, Economics and Policies". Fifth Edition p. 14.

success is because there are many forms that regional economic integration can take.

1.1 Regional Economic Integration: Concepts and Forms

When countries form an economic coalitions or integration, they attempt to exercise free trade in the hope of obtaining some of benefits of more open economy without sacrificing control over goods and services and over its market. However, countries, which enter into special trade arrangements will realize sooner or later that the more they eliminate the restrictions between participating countries, the more control of their economy is lost. Anyhow, the economic integration usually takes place in stages due to their complexity and degree of intensity. The stages are presented sequentially but there is no compelling reason to follow the sequence rigidly. The European Economic Community (EEC), for example, started with a Custom Union, not the least threatening one like Free Trade Area. However, the sequence is still helpful for clearer understanding and clearer picture of economic integration.

Forms of regional economic integration are diverse, involving combinations of various patterns of social, political and economic co-operation. There are several steps on the path toward full or complete economic integration. The various forms of regional economic integration that can be founded are:

<u>Preferential Trade Agreement (PTA)</u>

PTA is the most basic form of economic integration. The main feature of a PTA is to impose lower tariffs on imports from member countries than third countries. A very clear-cut example of PTA is ASEAN, which has experimented with PTAs before.

<u>Free Trade Area (FTA)</u>

A Free Trade Area (FTA) is often the staring-point and the most common integration scheme. Member countries in a Free Trade Area agree to remove tariffs to zero on each other's products over a specified period of time, while at the same time each member still retained its independence in establishing trading policies and different tariff levels with respect to non-member countries. In other words, the members of FTA can maintain individual tariffs and other trade barriers on the outside world. However, non-member countries may find it profitable to export products to member country with lowest level of outside protection and the export through other member countries whose protection against outside world are higher. This will cause import flooding into FTA member countries from the member country with the lowest external tariff. Hence, Rules of Origin are usually required in order to protect against this problem. In FTA, only goods can move freely between member countries. The mobility of capital and labor is usually restricted. The most prominent Free Trade Area has been the former European Free Trade Association (EFTA) and some other groupings like the North American Free Trade Agreement (NAFTA), and ASEAN Free Trade Area (AFTA).

Custom Union (CU)

Custom Union (CU) consists of a group of countries that eliminate trade restrictions within the region and the group adopts a common external commercial policy and a common external tariff applicable toward non-members. Furthermore, the group acts as one body in the negotiation of all trade agreements with non-members. In this stage, the transshipment strategy, which is used by non-member countries in order to escape some of trade restriction, will be eliminated. Hence, the Custom Union is a step closer toward complete economic integration than the Free Trade Area.

Common Market (CM)

A Common Market takes economic integration even further than a Custom Union. Trade Barriers are abolished between member countries and common external trade policy is adopted for non-member similar to that of the Custom Union. In addition, all barriers to factor movements among the member countries are removed. This form includes free movement of the factors of production -- labor, capital, and enterprise. The European Union (EU) has been a common market since the Maastricht Treaty of 1992.

Economic Union (EU)

An Economic Union includes all features of a common market but also implies the unification of economic institutions and policy throughout all member countries. There is a high degree of coordination of the most important areas of economic policy, market regulation as well as macro-economic and monetary policy.

Monetary Union (MU)

Economic Union is often used in combination with monetary union by creating either irrevocably fixed exchange rates, or one common currency circulating in all the member countries and creating a common central bank for carrying out the union-wide monetary policies. The European Union is the only regional grouping that has achieved this stage and hence the best example of this form of grouping.

Supranational Union or Total economic integration

Finally, Supranational Union is a stage beyond the Economic and Monetary Union but it is very difficult to achieve. The political aspects are united with single government entity among member countries. The introduction of supra-nationality is also presented in Political Union stage. This is finally called Total Economic Integration, which is the most comprehensive form of economic integration.

1.2 Regional Economic Integration: Theory and Benefit versus Cost

Theory of Economic Integration

Economic integration poses different treatment for participating countries as opposed to non-participating countries. Furthermore, economic integration can lead to shifts in the pattern of trade between participating and non-participating countries. It realistically means that there will be the expansion of intra-regional trade. Some may gain from shifting in trade pattern as a consequence of joining economic integration, but not all will gain, some may fail. However, the net impact on participating countries is still questionable. How and how much a nation may gain from joining economic integration is always raised in every nation's mind. No nation will want to join a union that reduces its economic well-being. The answer depends on several factors. Thus, the theories of economic integration were introduced in order to address gains and losses from joining economic integration. Before the formation, or pre-union, countries usually seriously study and analyze the net impact from joining economic integration by applying the theories of economic integration to correct the question of whether to gain or to loss from joining the union.

The regional integration is usually attempted in the form of Free Trade Area, especially in less-developed countries and even developing countries with their own different purposes. The aim of such move is to create a larger economic and investment spaces, larger market in goods and services for the benefit of participating countries. Moreover, the ultimate aim usually deals with static and dynamic gains from an expansion of regional trade and investment. The economic benefits of regional integration can be measured from static and dynamic gains and losses, which are illustrated by the Theory of Customs Union. As Free Trade Area and Customs Union share some common characteristics, the theoretical framework of customs union will be used to contribute further in analyzing the Free Trade Area theory. In explaining these two effects--static and dynamic effects, the theory of Customs Union will be paid more attention.

Theory of Customs Union

The effects of regional economic integration, (as mentioned here about customs union agenda) are generally distinguished into two types, namely Static effects and Dynamic effects.

- ***Static effects of a Customs Union***

Static effects (gains and losses) is used to described how customs union have effects or changes on the allocation of resources such as existing capital, labor, and other resources of the member countries. Additionally, the static effect examines both implications for trade as from resource allocation and for welfare of member countries.

1. Customs Union and Trade effects

The main characteristics of a customs union involve both free trade among its member countries (elimination of tariffs and other trade restrictions on imports from member countries and, at the same time, adoption of a common external tariff on imports from third countries and the rest of the world. Then, a customs union will have effects on the allocation of resources and have both positive and negative effects on trade.

There are two possible Static effects on trade, namely Trade Creation and Trade Diversion. Simply said, the positive static effect on trade is Trade Creation. Conversely, the negative static effect on trade is Trade Diversion. A positive static effect on trade occurs when the elimination of internal tariffs and other restrictions creates and stimulated new trade among the member countries. On the other words, foreign suppliers (Lower-cost producer) within the area can offer products at lower prices than domestic suppliers (High-cost producer). There is a shift from high cost producer inside the union to low cost producer also inside the union. This has positive effect for member countries, which is called "Trade Creation". On the other hand, a negative static effect on trade occurs when there is a replacement of low cost imports from third countries or outside the union by higher cost imports from partner countries. This is known as Trade Diversion, which has negative static effect on trade for member countries.

What made a customs union more likely to create trade rather than divert it? It would tell whether forming a customs union is worthwhile or not. First, *Economic size*-- the larger the size the greater the probability that the lowest cost producer will be located inside the union, the better the prospects for specialization and the smaller the risk of trade diversion. Conversely, a customs union of small economic size is more likely to induce trade diversion. However, the economic size might be limited by the substantial differences in national taste and preferences. Second, *Level of trade restriction* -- the higher the pre-union level of trade restrictions among the member countries, the greater the welfare gains from eliminating tariff, the greater the likelihood of trade creation in the products that were formerly protected against imports. A very restricted pre-union tariff implies the existence of highly protected national market and their remover lead to a rapid growth of intra union trade, which would have the trade creation. Third, *Economic distances* -- the smaller the distances among member countries, the greater the scope for trade creation because of low physical transfer costs, and low transportation cost. Hence, the closer geography would lead to trade creation. Finally, *Economic structure of the member countries* -- trade creation is enhanced when the economies of the member countries are very competitive and has overlapping patterns of production. This will enlarge the possibilities of resource allocation and specialization. Conversely, when the pre-union economies are complementary, the opportunities for new trade are limited, because the economies are already specialized with respect to each other.

2. Customs Union and Welfare effects

There are, also, two possible static effects on welfare, namely Trade Creation or positive welfare effect and Trade Diversion or negative welfare effect. However, the net welfare effect of a Customs Union would depend on the net balance of the production and consumption effects associated with trade creation and trade diversion.

The Positive welfare effect (Trade creation) has two components.

A. Positive Consumption effect

This effect leads to an increase in consumer surplus from substitution of lower-cost goods for higher-cost goods. Trade liberalization allows consumers to move to a higher level of satisfaction and consumer choices will increase.

B. Positive Production effect

Trade creation improves the world's economic efficiency by substituting lower-cost production for higher-cost production. This means that there is a saving in the real cost of goods formerly produced domestically. Finally, it leads to the efficiency in resource allocation and increase in trade volume.

The Negative welfare effect (Trade Diversion) also has two components.

A. Negative Consumption effect

Trade diversion has negative consumption effect, because it widens the gap between consumers' preferences and the production possibilities. There is the loss of consumer surplus owing to substitution of high-cost partner goods for lower-cost external goods. Finally, this effect reduces consumer satisfaction, which bring down the welfare gain to the union.

B. Negative Production effect

Trade diversion lowers the world's potential welfare by substituting higher-cost production within the union for lower-cost production outside the union. On the other words, there is an increase in the cost of goods formerly imported from overseas due to the shift from cheaper external source to partner countries. This effect also leads misallocation of resources and finally brings down the welfare of the union.

All in all, a customs union will improve world economic efficiency and potential welfare when trade creation outweighs trade diversion. However, the actual welfare depends not only on economic efficiency but also on income distribution. Then, income distribution needs to be taken into the considerations to evaluate the actual welfare effects.

- ***Dynamic effects of a Customs Union***

At this point, the impact of a customs union on trade and welfare analysis -- static effect have already been discussed. Now, the broader framework -- dynamic effects of a customs union will be discussed. Dynamic effects represent a permanent effect on the "Economic growth" potential of the integration area. A customs union can promote economic welfare not only by inducing higher allocative efficiency but also by stimulate economic growth, which can be called "Dynamic effect". Both static and dynamic provide rationale for customs union. However, as Baldwin (1993) point out that dynamic welfare gains are likely to be far greater than static welfare gains and hence provide a more compelling rationale for customs union. Nevertheless, static effect still gives a concrete explanation for customs union both trade and welfare agenda. There are many ways that a customs union may promote economic growth through dynamic effects. The most obvious consequence of free trade and customs union is "Market extension". Both producers and consumers enjoy free access to national market of all member countries. Reducing trade barriers and other restrictions bring about a more competitive environment, which will lead to an increasing level of efficiency. Greater competition enables firms to produce more with the same amount of inputs -- economies of scale and also improve technical efficiency or x-efficiency. In addition, access to larger union markets makes possible economies of scale in many industries. Economies of scales also bring about a specialization on particular types of goods. With a broader market, it intensifies more competition environment, and force to cut costs of production and sell more aggressively. This phenomenon stimulates greater intra-trade and intra-investment and finally results in higher economic growth of member countries in the union. The combination of economies of scale and competition also lead to an increase in enterprise size, whether through merger or acquisition. The bigger enterprise size, in turn, have more capacity to spend on research and development (R&D), adoption of new technology and better management practice, which result in higher and better product quality, and product innovation. Moreover, a bigger market induces new investment, which in turn promotes general economic efficiency and growth.

With new market opportunities, wider market, and tense competition, it is possible that integration will stimulate greater investments among member countries. It directly creates and supports the facilities for economic growth, which is a consequence of dynamic effect from the formation of customs union. Furthermore, it is also made of the reduction in risk and uncertainty for entrepreneurs. Facing with less uncertainty, therefore, entrepreneurs within the union are encouraged to make more investment. Consequently, the market is expanded over the long run and eventually stimulates higher positive growth effect to the union.

Benefits versus Costs to the formation of Regional Economic Integration:

Presently, international trade has become increasingly important, which can be observed through the higher export and import values in comparison with Gross Domestic Product (GDP). At the same time, almost every country is trying to improve its competitiveness in the world market. Some countries increased their production efficiency in order to be more competitive, while others try to object the importation by reducing export tax; increasing import tax and exercise even more trade barriers. Hence, GATT, which has now become WTO, was established with the objectives of Trade liberalization and agreements on the elimination of trade barriers. GATT and WTO believed that trade liberalization and free trade would bring the maximum net economic welfare gain to every countries and to the world market. But with the increasing trend towards international trade, inter-regional trade, and intra-regional trade, many countries thus develop trade negotiations by avoiding contradictions to GATT and WTO rules. Hence, regional economic and monetary integration is perceived as the viable way to make some real economic progress without violating the GATT and WTO rules.

Regional Economic and Monetary Integration yield great benefits, on the other hands, it also involves costs to the participating counties. In the other words, regional economic integration can either helps or hurts a nation. The participating countries of regional economic integration usually decide to join the unification due to the expectation of the possible gains they will achieve. The possible gains and losses, thus, should be analyzed thoughtfully. The benefits and costs to the formation of regional economic integration can be briefly summarized as followed:

The **Benefits** from the formation of regional economic integration

There are some strong arguments for regional economic integration. Since there are various stages of regional economic integration, the benefits on economic gains from economic integration can be attributed according to stages as:

At Custom Union (CU) and Free Trade Area (FTA) level:

1. The greater intra-regional trade and investment is stimulated.
2. Better and larger term of trade due to the cheaper imports from the outside world and higher price for exports.
3. The greater bargaining power position
4. Increasing in specialization leads to the enhancement of production efficiency and technological advance.
5. Size of market will be larger and stronger.
6. Influence both local and regional real investment
7. Both trade creation and trade diversion yield net gain to participating countries.[3]
8. Both trade creation and diversion may lead to increasing efficiency due to the economies of scales.[4]
9. Expansion of its member's countries welfare

At Common Market (CM) level:

There are not only benefits from Custom Union and FTA level, but also the additional benefits can be gained at Common Market level, which is the higher national income due to the factor mobility across the borders of participating countries.

At Economic and Monetary Union (EMU) level:

At this stage, the participating countries unify their fiscal, monetary, and all other economic policies as common policy. The coordination of monetary and fiscal policies; and further forming single currency may result the benefits in:

1. Abolition of the exchange rate risk and desirability of the exchange rate certainty: the most outstanding benefit, which finally leads to the economic stability.
2. Elimination of the transaction and conversion costs.
3. Reduce price uncertainty.
4. Improve welfare of the union due to the improvement of the allocation efficiency of price mechanism.
5. Elimination of speculative capital flows within the area.

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[3] Ali M. El-Agraa, "The European Union: History, Institutions, Economics, and Policies", Fifth Edition of the Economics of the European Community, 1998, p. 92.

[4] Ibid.

6. Consumers are better-off due to the price transparency because all products are priced in the same currency and the market will be more competitive.[5]
7. Unification leads to better employment level, lower inflation rates, and balanced trade.
8. Better income distribution.

The **Costs** from the formation of regional economic integration:

There are, however, some arguments against the formation of regional economic and monetary integration. The possible conflicts of interests might occur among member countries. No one does something for nothing. Like any country, each country joins regional economic integration with different purposes, different expectation, and different interests. Participating countries usually expect for their own maximum interests. No countries would want to sacrifice what they might gain, from what they had done. The conflict of interests among participating countries probably leads to some obstacles and causes the negative economic welfare to the region. Even more, the progress of economic integration of the region would be blocked up. Hence, the proper arrangement of the member countries' interests must be well-organized and seriously considered. Furthermore, some countries, especially smaller countries and those with poor economic performance, rely too much on the larger or leading countries of the region. This situation could caused unreal growth of those small countries and worse, that possibly lead to long-term negative effects to the region. Finally, those small countries might be isolated from the participation.

In addition, on the Custom Union (CU) level, economic integration could hurt a nation if there is high level of trade diversion against trade creation of forming a Custom Union, somehow, it would reduce the nation's economic welfare. Due to establishing a common external tariff, the international trade between member and non-member countries tends to decline. If prior to the formation of economic integration, member countries gain from international trade with the outsider or non-member countries, the common external tariff leads to the reduction of member countries' economic welfare. Additionally, due to the reduction of internal trade barrier, the regional economic integration may diminish the level of international trade between the region and the outside region or the rest of the world. Consequently, the outsiders or the rest of the world will be

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[5] Sabhasri Chayodom, "Theory of Optimal Currency Area and the Euro". Chulalongkorn Review, No 41 October-December 1998, p. 109.

worse-off from the formation and the world welfare will fade out finally. Since Custom Union can both expand and reduce its members' economic welfare and even more leave the region and the rest of the world worse-off; the region better-off; but the world worse-off; or both the region and the world better-off. Hence, the economic integration should be considered whether there is positive or negative net welfare effect to the nation, region and the world.

On the Economic and Monetary Union (EMU) level, the main cost of joining a monetary union is the loss of monetary policy independence or loss of sovereignty in monetary policy to stabilize economic disturbances or to eliminate a country specific shock. Once in the EMU, monetary and fiscal policies had to be tightened and united among countries. Furthermore, both monetary and fiscal policies need to be followed accordingly as stipulated. On the other words, when a nation join an EMU, the formation of monetary and fiscal policy is no longer made at the national level but rather at monetary union level. Each country has different level of inflation rate. Particularly, countries with an underdeveloped tax system will find it more advantageous to raise revenue by using inflation tax (seigniorage), which is less costly than increasing tax rates. Hence, those countries usually use seigniorage in order to increase government revenue instead of increasing tax rates. However, countries, which participate in EM are not able to use inflation tax freely. The use of inflation tax or seigniorage is under control at some certain level. This requirement or control leads the costs to particular nations. Less developed countries, for example, that join an EMU with more developed countries that have a low rate of inflation, will also have to lower inflation as the required convergence criteria for joining an EMU. This means that less developed countries have to increase tax rate to restore their economy, which is more costly to the country and can even lead to deficit further on. Finally, there will be a loss of welfare. Moreover, there is a long-run trade-off between unemployment and inflation. Suppose now that country A and country B have different inflation rate and unemployment level. It is obvious that fixed exchange rate is not practical to perform. To keep the exchange rate fixed as EMU, they have to choose possible costs. Like, country A has to accept less inflation and more unemployment than it would do, otherwise, country B has to accept more inflation and less unemployment. That is the reason why a nation pays a high price in joining single currency or a currency union in that monetary policy can not be used as a means to equilibrate between inflation and unemployment.

All in all, there are both the arguments for and the arguments against the formation of regional economic integration. However, the arguments for outweigh the arguments against. This means that even if there are costs associated with the formation of regional economic integration, the benefits outweigh those costs. But it is still essential to consider all possible supporting factors against the required criteria in the formation of an integration whether it costs too much to a nation and nation's welfare.

1.3 Market led and Institutional based integration

There are different approaches to regional integration. Each of them reflect different objectives and having different effects. Market-led integration and Institutional-based integration are also those approaches to regionalism or regional bloc. The distinction between regional integration led by market force and that driven by institutional development will differentiate Asian regionalism from the European Union and NAFTA. Hence, the nature of market-led integration and institutional-based integration will be mention here at the first place. Market-led integration remains the essence of economic integration. Market integration is a behavioral notion indication that activities of market participants in different regions or member countries are geared to supply-and-demand conditions in the entire union. It usually occurs in the form of cross-frontier movements of goods, services, and production factors. Compared to market-led indication, Institution-based integration is associated with the establishment of common institutions that represents the group as a whole. Virtually, all efforts in the world economy to pursue economic integration are subjected to severe constraints imposed by national sovereignty. Institutional-based integration is one way in preparedness to go in removing political barrier to pursuing economic integration. This approach does not imply a total loss of sovereignty but rather "Pooling the sovereignty", or Supranationality. The features of market-led integration occur mainly in Asia, meanwhile the institution-based integration is obviously seen in the region of Europe. Normally, once a high degree of market integration has been accomplished, the union level may find it more effective to share the enforcement and executive functions with the institutions of the member countries. But it is not the enforced rules that which stage (whether Market-led or Institutional-based integration) should come in which order. European union has been perceived as "Market-led integration". But due to many reasons behind these changes, especially the crises within the region, European Union began to change gradually from market-led integration to stronger institutional-based integration. They, European Union, realized that for a stronger and more closer union, the institutional-based is a very important issue which needs to be addressed.

In actual practice, both market-led and institutional-based are hardly contested. It is hard to trace which one has influenced the mature and process of economic integration. Both are weigh equally to such an important area. Without nation-state or even government, economic integration would boil down to pure market integration. But in the real world, economic integration is always to some extent political and institutional process. From previous part, concept and form of integration, the stage of economic integration has been distinguished. Those stages are presented sequentially from "Free Trade Area (FTA)", which reflects upon market-led integration to "Supranationality", which reflects upon institutional-based integration. Hence, the essence of economic integration needs to practice these two concepts -- market-led & institutional-based integration.

In actual practice, the European Union, the most successful economic grouping, has been passed through the stages, which represent the market-led integration. And now, they are binding for the stages of institution-based integration with the ultimate objective of supranationality. In the same path, the Asian countries are moving in the same direction with the European Union. Asian countries are presently in the early stage of economic integration and are classified as market-based integration. Moreover, Asian countries tend to be deepening and widening with an increasing ambition for economic integration. It is quite clear that sooner or latter Asian grouping could achieve the higher stage of economic integration and have stronger institutions for more closer-union, and could become the successful economic grouping as European Union.

Economic Blocs

European Union (EU)

Undoubtedly the most ambitious and best known regional economic integration effort, the European Unions is also the most successful one. This grouping of the 15 member countries is probable one of the most sensible and practical economic integration at the moment, due to the geographical closeness of the members and the level of economic development, which are all pretty much on similar ground too. But the European Union is also the oldest integration effort, and has come a very long way since 1951, when the first formal integration effort was attempted on that continent, with the signing of the Treaty of Paris. The treaty established the European Coal and Steel Community to coordinate the production, distribution, and other matters concerning these two industries within the six member countries of Belgium, France, West Germany, Italy, Luxembourg, and the Netherlands. The cooperation among the six countries gained momentum, which resulted in the establishment of the European Atomic Energy Commission (Euratom or EAEC) and the European Economic Community (EEC) with the signing of the treaty of Rome in 1957, with the term European Communities (EC) referring to all three together.[6] Other objectives of the Treaty of Rome was to establish the foundation of an even-closer union among the European people, to provide for a common market in services, labor, capital and goods -- the Four Freedom -- between the members and to try and establish a Customs Union by 1969. The EC was very successful, and membership was subsequently expanded from 6 to 15, with the addition of Denmark, Ireland, and the United Kingdom in 1973, Greece in 1981, Portugal and Spain in 1986, and Austria, Finland and Sweden in 1995.[7]

And as a testimony to EU's ambition and determination in wanting to facilitate and reach the unprecedented stage of Economic and Monetary Union is the establishment of various supranational institutions. *The European Commission*, the executive body of the EU, is responsible for implementing the treaties and general leadership. The administrative role of the commission is to manage EC funds and programs and to deliver aid to other countries. EC makes policy proposals and presents them to the Council of Ministers. *The Council of Ministers*, the main

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[6] Regionalism and World trading system; World Trade Organization Geneva, April 1995, p. 29.

[7] Appleyard R. Dennis, Field J. Alfred, JR., "International Economics", Third Edition 1998, Davison College, University of North Carolina at Chapel Hill, p. 364.

lawmaking body of the EU, is the decision-making unit on community wide matters. Council of Minister is comprised of a single representative from each of the member states. The council cannot draft legislation, but it can accept, reject, or request proposals from the commission. The council is aided by the Committee of Permanent Representative, which is comprised of the permanent representatives (or ambassadors) of each member state. *The European Council*, comprised of the political leaders of the individual member countries, sets broad policy guidelines. Summit meetings are called at least once every six months by the country holding the presidency of the Council of Ministers. *The European Parliament* is elected by voters in the member countries (with a specified number of seats allocated to each country), and it makes proposals to the Commission. The European Parliament also works with the Council of Ministers on the EU budget and can reject a budget plan if agreement cannot be reached within the council. Finally, *the Court of Justice*, the final arbiter in all matters of EU law and integral part of the institutional structure, interprets the constitution and settles disputes.[8] The Court is composed of 13 judges who are appointed to six-year terms, with at least one judge from each member country. The court deals with disputes between member governments and EU institutions and among EU institutions, and with appeals against EC rulings or decisions. The court makes binding rulings on EU law to help guide the rulings of national courts. The rulings of the Court of Justice set legal precedents and become part of the legal framework of each member countries. Hence, it is undeniable that no other economic integration is as well-prepared, or as well-equipped to progress further upon the economic integration path as the EU.

A further deepening and strengthening of economic and political ties among the EC members occurred as a result of the Maastricht Treaty signed in 1992, the treaty entered into force in November 1993. The treaty expanded on EC's primary aim of promoting economic and trade expansion within a common market by embracing the objectives of monetary union, a common foreign and security policy, common citizenship, and the development of cooperation of justice and social affairs.[9] Another important issue discussed at the signing of the Maastricht Treaty was the possible adoption of a single currency for the member countries. In March 1989, the European Monetary System (EMS) was established as a first step toward achieving an Economic and

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[8] Appleyard R. Dennis, Field J. Alfred, JR., "International Economics". Third Edition 1998, Davison College, University of North Carolina at Chapel Hill, p. 364.

[9] Regionalism and the World Trading System; World Trade Organization April 1995, p. 31.

Monetary Union, called EMU. A goal on establishing a common European currency (EMU) was set for 1999. The EMS was proposed to stabilize exchange rates and curb inflation by limiting the margin of fluctuation for each member currency to a small deviation from a central rate. A common European Currency Unit (ECU) was introduced by which the central exchange rates could be set. The ECU is comprised of all the EU currencies, weighted according to the economic importance of each country. When any currency reaches the limit of the margin of fluctuation, which is set at 2.25 percent, the central banks of the respective countries must intervene by selling off the stronger currency and buying the weaker one. EMU objective is to reach price stability of currency by pooling Euro-currency into single currency (European Currency Unit) and to establish regional central bank - ECB, European Central Bank. . To be qualified for EMU, the applicant members have to achieve the four convergences criteria which are :

- Low Inflation : No more than average of the lowest three inflation rates in the EU plus 1.5%
- Government Debt : No more than 3% of GDP
- National Debt : does not exceed 60% of GDP
- Low and Stable Long-term Interest Rates : No more than the average yield of the three best performers plus 2%.

The European Monetary Union (EMU) is at an experimental stage, with 11 of the members, aiso referred to as the ins, consisting of Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain using the new single currency, the Euro. By 2002, the Euro will completely replace the ins' currencies, and may or may not be joined by the four remaining members. The next steps after EMU is, undoubtedly supranational integration. And the EU is poise to break new ground when it reaches that stage, and with the success that EU have been having, that stage is no longer just a distant dream, but in fact, may be a good that will be realized sooner rather than later.

North American Free Trade Area (NAFTA)

Although NAFTA negotiations were concluded in August 1992 with the establishment of a draft agreement, when the United State, Canada, and Mexico concluded negotiations to eliminate trade and investment barriers among them, economic integration on that continent has a deeper root than that. At first step, the process of regional economic integration of North America was taken in 1965 with the conclusion of the US-Canada Automotive Agreement. There was tariff-free trade in motor vehicles and parts between the US and Canada. A few year later, there was a bilateral trade between the US and Mexico so called the development of the Maquiladores. After that, there have been extensive negotiation since 1985 and have had US-Canada Free Trade Agreement 1988. This agreement provides for the gradual elimination of import duties and quotas over a ten-year period form 1 January 1989 and a reduction in barriers to trade in services and direct investments. The next golden wave of North American regional economic integration was the conclusion of a North American Free Trade Agreement (NAFTA) in which the US, Canada and Mexico participate. The negotiation began in June 1991 with the objectives of to eliminate restrictions on movements of goods, services and direct investments between the three countries and to protect intellectual property rights. The draft agreement was concluded in August 1992. Then, the North American Free Trade Agreement (NAFTA) was ratified in January 1994 as Free Trade Area among the three North American nations -- the US, Canada, and Mexico. NAFTA has an internal market of over 387 million people with a GDP of over $7.7 trillion, and average per capita GDP of about $20,560.

NAFTA is a comprehensive free trade agreement that addresses all aspects of doing business within North America. It eliminates all tariffs on North American industrial and agricultural products traded between Canada, Mexico, and the United States within 10 years of implementation. NAFTA also eliminates non- tariff barriers, including import licenses, provides high standards for protection of intellectual property rights, guarantees fair and open competition for government procurement, and removes investment barriers and performance requirements on investors that restrict the trade of goods and services. Furthermore, three members also agree to extend "national treatment", where foreign own services firms will be treated exactly like domestic firms to each other. Overall, it can be summarized that the main objectives of NAFTA are to

i) To eliminate all tariffs by 1998 and substantially reduce other trade barriers and restrictions on both goods and services.
ii) To promote fair competition and to liberalize trades in all areas.
iii) To liberalize conditions for investment.
iv) To build the foundation for further bilateral and multilateral cooperation.

NAFTA is quite unique in that it is an integration with a dominant country, the USA., accounting for nearly nine-tenths of NAFTA's GDP.

The US economy is about ten times the size of Canada's and twenty-five times the size of Mexico's. Another interesting aspect of NAFTA is the wide gap between the US and Canada on the one hand, and Mexico, on the others in their levels of economic development, as indicate by per capita GDO and average wage per day. On the contrary, the EC or EU now has no such dominant country and its members are on about the same level of development.[10] Additionally, unlike the EU, NAFTA is neither a customs union nor a common market -- there are, for example, no plans to create a North American monetary system or a common agricultural policy. There are some fundamental differences between EU and NAFTA. The EU economies are more open than the NAFTA economies. This means that the costs and benefits of economic integration bare more heavily on its members than they do on the NAFTA countries. Furthermore, NAFTA has broke new ground by becoming the first free trade area comprising both industrial and developing countries. And due to the large gap between the three members, many economist views NAFTA with skepticism. They believe the US can not benefit from trade with a poor country like Mexico and some going as far as saying that NAFTA will cost US jobs, induce US firms to more to Mexico and cause Mexican exports to flood the US market. It is undeniable that Mexico, the poorest of the three member countries will benefit the most from this arrangement, but to do so it will need to make the biggest structural adjustment of the three countries. But despite the skepticism, criticism, and the seemingly insurmountable gap between the US., Canada, and Mexico, NAFTA have been quite successful so far and look to become even more successful and on target to follow closely in the footsteps of the EU in the new Millenium.

Asia Pacific Economic Cooperation (APEC)

Having been initiated in November 1989, in Canberra, Australia where twelve countries signed the agreement. The Asia-Pacific Economic Cooperation (APEC) was established in response to the growing interdependence among Asia-Pacific economies. Today, APEC includes all the major economies of the region and the most dynamic, fastest growing economies in the world. The membership of the APEC has continually expanded, with Peru, Russia and Vietnam became the latest members of the APEC community at the 10th APEC Ministerial Meeting, held on 14-15 November 1998 in Kuala Lumpur, Malaysia. The twenty-one member countries are Australia, Brunei, Chile, Canada, China, Hong

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[10] Root, Franklin R., "International Trade and Investment" Seventh edition, p. 278.

Kong, Indonesia, Japan, the Republic of Korea, Malaysia, Mexico, New Zealand, Papua New Guinea, Peru, the Philippines, Russia, Singapore, Taiwan, Thailand, the United State of America, and Vietnam. It is quite obvious from the list that the community is made up of the major economies of the region and is quite diverse in nature as well as having differing levels of economic development. But the differences and the gaps have not slowed down or hindered APEC 's process, and their success is evident from the combined GDP of the 21 members, which was around US$ 16 trillion, and 45 percent of the global trade was APEC 's contribution.[11] The success of APEC has been carefully built upon the three pillars of their activities; trade and investment liberalization, business facilitation and economic and technical cooperation. As a matter of fact, APEC is one of the few international organization that place so much emphasis on investment and business facilitation, as evident from the regular involvement of the private sector in a wide range of APEC activities. And although most of the members of APEC are also members of other sub-regional organizations and groupings, this does not seem to affect APEC 's efficiency and APEC seems to be getting stronger as the new Millenium approaches.

Sustained economic and world growth have been APEC 's main aim since its inception in 1989, and now 10 years afterwards APEC still follow closely along the same path, and so far their growth have been achieved through trade and economic cooperation. Liberalization is also a high priority in APEC 's agenda, and in 1994, the members agreed on an ambitious plan for free and opens trade and investment in the region, to be achieved by 2010 for the developed members and 2020 for the developing ones. For the next Millenium, the leaders of APEC also agree that special attention need to be given to the following six areas of economic and technical cooperation to achieve their goals; developing human capital, fostering safe and efficient capital markets, strengthening economic infrastructures, harnessing technologies of the future, promoting environmentally sustainable growth and encouraging the growth of small and medium-sized enterprises. The APEC community also realizes that they must develop region-wide practices and policies to encourage the free flow of goods, services, investment, and capital within the region. And if they stick to these ideas and walk on the same path that they have been walking, they can achieve concrete and pragmatic results that will benefit business, contribute to increased income and create jobs in the region.

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[11] Internet

Association of South East Asian Nations (ASEAN) and ASEAN Free Trade Area (AFTA)

The Association of Southeast Asian Nations or ASEAN was established on 8 August 1967 in Bangkok (as Bangkok Declaration) by the five original Member Countries, namely, Indonesia, Malaysia, Philippines, Singapore, and Thailand. Brunei Darussalam joined on 8 January 1984, Vietnam on 28 July 1995, Laos and Myanmar on 23 July 1997, and Cambodia (the most recent and final member of the association) on 30 April 1999. The first five founding member of ASEAN joined force to work towards achieving economic development and growth and improving the welfare and condition of life for their population. The Association was formed with first three aims and purposes of ASEAN as follows:

i) To promote and to accelerate the economic growth, social progress and cultural development in the region through joint endeavors in the spirit of equality and partnership in order to strengthen the foundation for a prosperous and peaceful community of South-East Asian Nations;
ii) To promote active collaboration and mutual assistance on matters of common interest in the economic, social, cultural, technical, scientific and administrative fields, and to serve as a forum for the resolution of intra-regional differences, and perhaps most importantly
iii) To promote regional peace, stability, and political security through abiding respect for justice and the rule of law in the relationship among countries of the region.

ASEAN is interesting in that its members are quite diverse, in terms of size, population, level of economic development, natural resource endowment, economic structure and political structures and stability. Altogether, the ASEAN countries have a land area of around 4.5 million square kilometers, larger than that of EU, with a population of about 500 million and a combined gross domestic product of US$ 737 billion, and a total trade of US$ 720 billion.[12] In 1991, the member agreed to establish an ASEAN Free Trade Area (AFTA) by the year 2008, but was later shortened to 2003, reflecting the seriousness and commitment of the ASEAN government. In addition, changes in the economies of ASEAN countries were also creating pressures for the establishment of

[12] Internet

AFTA. Under AFTA, all ASEAN countries participate in a Common Effective Preferential Tariff (CEPT) scheme. This would include all agricultural goods and all manufactured goods. The strategic objective of AFTA is to increase the ASEAN region's competitive advantage as a single production unit. The elimination of tariff and non-tariff barriers among the member countries is expected to promote greater economic efficiency, productivity, and competitiveness.

ASEAN cooperation has resulted in greater regional integration. Within three years from the launching of AFTA, exports among ASEAN countries grew from US$43.26 billion in 1993 to almost US$80 billion in 1996, an average yearly growth rate of 28.3 percent. In the process, the share of intra-regional trade from ASEAN 's total trade rose from 20 percent to almost 25 percent. Today, ASEAN economic cooperation covers the following areas: trade, investment, industry, services, finance, agriculture, forestry, energy, transportation and communication, intellectual property, small and medium enterprises, and tourism.

The main successes of ASEAN though, have been in the political sphere by promoting regional peace and stability, best exemplified by its key role in ending the Cambodia Civil war in 1991.[13] Most economists, however, view ASEAN 's efforts and achievements in the economic sphere as modest, at best. It is undeniable that peace and stability have paved the way for and facilitated rapid economic growth throughout the region, but the low level of intra-regional trade which has risen only modestly only serve to leave further the minds of some economist. Others, however, see ASEAN as a model for effective regional cooperation among developing countries, and view the close political cooperation, discrete diplomacy, consensus-building and non-interference as the cornerstone and the benchmark of ASEAN. But at the time when other regional groupings such as the EU having reached unprecedented success with the formation of the Economic & Monetary Union, and the recent success of NAFTA, ASEAN 's achievement is dwarfed in comparison. The pressure will be on ASEAN to duplicate its political success in the sphere of economic cooperation in order to progress to the next stage of the integration and launched the much anticipated ASEAN Century.

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[13] Park Donghyun, "The prospects for further economic integration in ASEAN". Journal of economic integration, Volume 14 number 3, September 1999, p. 383.

1.4 Integration through the Theory of Interdependency and Optimum-Currency-Area

There are several ways in studying regional economic integration. In this work, the focus will be on the theory of Optimum-Currency-Area, and supported by the study of Interdependency.

1.4.1. The Theory of Optimum Currency Area

What is an Optimum Currency Area? The basic answer is a region, not necessarily a country, where it makes sense to employ one currency. Such an area may include more than one country, in which case the countries may adopt a common currency or national currencies that are tied together under a system of fixed exchange rates.

What can tell whether which nations constitute an optimum currency area? It depends on the following precondition criteria, which identified as relevant for choosing the likely participants in an optimum currency area.

(i) *Similarity of inflation rate.* Inflation convergence is one of the criteria that needs to be satisfied for entry into the monetary union. By pegging the exchange rate to the currency of a country with a low inflation rate, the nation's monetary policy will be credibility. Hence, the similarity of inflation rate is required along the path to monetary union.

(ii) *The degree of labor mobility.* Labor mobility between countries reduces the necessity of exchange rate variation. Furthermore, regions between which there is a high degree of labor mobility are viewed as better candidates for currency area membership because such mobility provides a substitute for exchange rate flexibility in promoting external adjustment (Mundell 1961)

(iii) *The degree of financial integration.* A high degree of financial integration is needed for helping financial interregional payments imbalance.

(iv) *Trade integration.* The more concentrated is a country's trade with a subset of partner countries, the grater the saving in transaction costs associated with the use of single currency. (Eichengreen, 1994. Page 80)

(v) *The degree of commodity diversification.* The more diversified economies, the more it prevents against a variety of shocks, forestalling the need for frequents changes in terms of trade or in relative price via the exchange rate mechanism. Hence, highly diversified economies are viewed as better candidates for currency unions than are less diversified economies.

(vi) *The openness and size of the economy.* The more open the economy, the more fixed exchange rate arrangement is preferred. Because the nominal exchange rate changes in such economies are less likely to be accompanied by significant effects on real competitiveness. Hence, the smaller the size of the economy, the more open it is likely to be and, thus the more inclined to join in a currency union.

(vii) *Fiscal integration.* The higher the level of fiscal integration between two areas, the greater their ability to smooth out diverse shocks through fiscal transfers from a low-unemployment region to a high-unemployment region. (Kenen 1969)

(viii) *The degree of goods market integration.* Countries with similar production structures are deemed to be better candidates for currency unions than are countries whose production structures are markedly different.

This conceptual theory concentrates on analyzing those conditions necessary to make a region optimum. For those countries, which pose above criteria will be likely to join the monetary or currency union.

1.4.2. The study of Interdependency

How regional economic integration can be explained by applying the theory of interdependency? There are several ways of thinking about interdependency. Some may think about trade interdependency, or financial interdependency, or even more some may think about political interdependency. Whether what forms it may concern, the ultimate goal is that of the way toward regional economic integration. For stronger economic power, stronger bargaining power, stronger political power, all are what every country need. That is why the theory of interdependency is needed to be a guiding light of regional economic integration.

The degree of integration among groups of countries is usually measured by Trade Flows. But the examination is not only the trades flow like simple export and import value or volume but also, more specifically, that of the pattern of foreign direct investment (FDI). The trade flow within the region, simply say the intra-regional trade, provides the guideline of regional integration, which can be observed through the increasing volume of export and import within the region. Furthermore, an analysis of FDI into and within each region of the world can therefore provide clues to the degree of existing integration, to the future pattern of that integration and to the fundamental driving forces behind it.

The rapid growth of intra-regional trade stimulates the world attention to the importance of regional trade arrangement and trading bloc. Hence, the high level of interdependency (whether on trade, financial or even political interdependency) within the region, the high possibility of forming regional economic integration.

Hence, the next chapter will focus on regional economic integration in East Asia. The comparative analysis both in trade interdependency and Optimum-Currency-Area pre-condition criteria will be shown. Additionally, the individual economic overview of the countries will be mentioned in Appendix A.