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Regional integration: A worthwhile strategy for catching up?

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Regional Integration - A Worthwhile Strategy for Catching Up?*

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I. Introduction

As a response to the slow progress of the GATT negotiations, the 1990s saw a revival of regional integration attempts [see e.g. Bhagwati, 1993].[1] Especially developing and newly emerging market, i.e. low income, economies hope that regional integration offers a viable strategy for catching up with developed, i.e. high income, economies. This is rather surprising in light of past experience. Policies towards regional integration among developing countries were implemented half-heartedly and often in an inconsistent fashion, were abolished after a relatively short period of time, or were neutralised by new, mostly non-tariff barriers [Langhammer, Hiemenz, 1990, pp. 18-60]. Member countries of most so-called customs unions did never grant duty-free market access to each other, and efforts towards trade liberalization were either limited to more or less redundant tariff barriers or were aborted early. Even customs unions inherited from the colonial past soon broke up after the member states gained independence or disintegrated because new tariffs or non-tariff barriers were erected.

It may be argued, however, that such an outcome is to be expected from regional integration among low income countries, i.e. from South-South integration, whereas regional integration with high income countries, i.e. North-South integration, is a more viable strategy. In Europe, Greece and Portugal have already been successful in joining the European Union (EU) and the newly emerging market economies of Poland, Hungary, the former Czechoslovakia, Romania, and Bulgaria are queuing up for entry into the rich country club [Schmieding, 1992a]. On the other side of the Atlantic, the North American Free Trade Area (NAFTA) has been established which includes Mexico [Langhammer, 1992b] and sends first encouraging signals to Chile and Argentina. However, the merits and flaws of regional integration, either South-South or North-South, can only be assessed by comparing it with unilateral integration, i.e. with opening up for the entire world market. This paper evaluates the economic effects which low income countries could expect from the three alternative strategies and tries to figure out possible advantages of regional integration for catching up with high income countries.

The structure of the paper follows the literature [e.g. Balassa, 1962, p. 2] in assuming that regional integration is a sequence of four steps: the integration of goods markets (Section II) and the deepening of integration by the integration of factor markets (Section III.1.), monetary integration (Section III.2.), and fiscal

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[1] For an overview, see e.g. Hammes [1993] and Inotai [1991].

integration (Section III.3.). Each section reviews the theoretical arguments and shows the relevance of this arguments for low income economies. Section IV gives a summary and policy conclusions.

II. Which Integration of Goods Markets: South-South, North-South, or Unilateral?

Goods markets integration basically means to liberalize trade. Four types of liberalizing trade can be distinguished [Jovanovic, 1992, p. 9]:

- Preferential tariff agreements, i.e. partner countries impose lower customs duties on mutual trade than on trade with third countries;

- Free trade areas, i.e. partner countries eliminate all tariffs and quantitative restrictions on mutual trade with every country retaining its own tariff and other regulations on trade with third countries;

- Customs unions, i.e. partner countries agree on free trade with each other and on a common external trade regime;

- Unilateral liberalization, i.e. single countries reduce all trade barriers with respect to all countries to the same extent.

The first three alternatives for trade liberalization listed above constitute regional integration schemes, i.e. integration with partner countries. The following concentrates on the customs union case when analyzing regional integration because a customs union integrates preferential and free trade elements so that the effects of preferential tariff agreements and free trade areas can be easily derived.[2] Therefore, low income countries opting for the integration of their goods markets have three basic options:

- regional integration with other low income countries, i.e. South-South integration;

- regional integration with high income countries. i.e. North-South integration;

- world market integration, i.e. unilateral integration.

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[2] In the following, a detailed analysis of all trade related measures is avoided in order to draw on general arguments rather than on specific policies. The implicit assumption is that tariff equivalents can be calculated for all trade related measures. To talk about tariffs exclusively seems to be justified because there is a consensus in the literature that tariffs are superior to indirect measures. Therefore, the first step of each trade reform, the transformation of non-tariff into tariff barriers, is not debated here.

The relevant question is which integration path a low income country should choose. In economic terms, the answer should be based on differences in the discounted benefits to be expected for all future periods. Hence, the dynamic effects of integration should matter more than the short-run, static effects. However, in politico-economic terms, the static effects gain importance because these effects can be more easily related with the integration policy. Moreover, governments can either be subject to the pressure of strong interest groups which oppose liberalization or politicians and bureaucrats themselves may benefit from trade restrictions through their stakes in inefficient public or private enterprises or through their control over non-tariff and tariff barriers.[3] If negatively affected in the short-run, the vested interests due to the subordination of government decision under individual welfare considerations may inhibit liberalization.

Therefore, both static *and* dynamic effects of integration matter. While the static effects address more the positive question if and which type of integration *can* be established, the dynamic effects address more the normative question which type of integration *should* be established.

1. Static Effects of Goods Markets Integration

The Vinerian customs union theory [Viner, 1950] exposes two static effects of liberalizing intra-regional trade: partner countries imports replace domestic production (trade creation) and partner countries imports replace imports from non-partner countries (trade diversion). Both effects emerge as a result of liberalizing trade among each other and from changing relative prices between imports from partner and non-partner countries.

The necessary precondition for a customs union to have any effect is that market driven integration between partner countries is to be expected in the absence of trade barriers. Market driven integration, in turn, only occurs if the products of partner countries are at least as cheap as domestic products and the products of non-partner countries (including the external tariff). Whether or not this is the case depends on transaction costs and on the competitiveness of partner countries.

Transaction costs are determined by information costs, transport costs, and costs due to expropriation and default risks [Amelung, 1991]:

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[3] See Langhammer, Hiemenz [1990, pp. 70-72] on this point and on its relevance for developing countries.

- The processing of information facilitates an orderly decision-making process on part of the trading partners [Bates, 1988]. Such processing is facilitated by cultural, social, religious and ethnic affinities.

- The protective effect of transport costs[4] tends to be lower for goods with a rather high value added, low weight and small size, e.g. durable consumer goods and capital goods [Langhammer, 1987]. By contrast, raw materials and non-durables show a higher intensity of transport costs. Transport costs between two countries can also be extremely high if the infrastructure, i.e. railroad tracks, roads, and harbours, is not well developed.

- The equivalent of transport costs in capital transfers are the transfer fees charged for the transfer of capital between two countries. Given the technical progress in the banking sector, distance has no impact on the level of transfer costs. However, the costs of capital transfers depend on the availability of an infrastructure providing market-making activities, i.e. a modern banking sector and international communication networks [Thiessen, 1988, Ch. 2].

- The risks of expropriation and default also add to transaction costs. The trading partners can engage in market-making activities that increase the reliability of transactions, and reduce the incentives for breaking contracts. This is done through contractual arrangements which are much more complicated than trade on the national level [North, 1987]. Most importantly, impersonal exchange with third party enforcement requires extensive legal cooperation between authorities of two countries. A precondition for such a cooperation is a bilateral adjustment of law codes and a willingness for political cooperation. Two substitutes for this arrangement are possible. First, exporters can set up subsidiaries in foreign countries and thus become multinationals that are legally treated as domestic firms. This leads to an internalization of transaction costs [Williamson, 1979]. Second, reliable banks can set up various document-against-payment schemes. Trade can be expected to flourish when there are

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[4] The effect of this obstacle to trade on the direction of trade has been broadly discussed in the literature on the customs union theory [e.g. Balassa, Stoutjesdijk, 1984; El-Agraa, 1988]. Earlier works in location theory [e.g. Lösch, 1954] have asserted that given increasing freight costs markets may reach a maximum geographical extension, beyond which there is no demand for the good because of prohibitive transport costs. Following Deardorff [1987], transport costs are natural trade barriers in the sense that some goods and services may only be traded within delimited regions thus being non-tradables outside the respective region, while other goods are traded worldwide.

well-developed international banking systems in the home countries of the transactors. Such a financial system constitutes market-making activities reducing transaction costs.

The determinants of transaction costs suggest that market driven integration is to be expected in geographic regions [Lorenz, 1992]. Hence, regional integration policies should be more effective than world wide integration. However, the determinants of transaction costs also suggest that the chances for market driven integration are significantly lower for South-South than for North-South integration. This is due to a high share of raw materials and non-durables in mutual trade, poor infrastructure and banking services, as well as restrictive regulations for foreign direct investment.

The effectiveness of South-South integration is further impaired by competitiveness considerations. Partner countries with a similar level of development and similar resource endowments have little scope for inter-industry specialization and partner countries with a relatively low level of development do not have the option of intra-industry specialization either [Langhammer, Hiemenz, 1990, p. 68]. Hence, both transaction costs and competitiveness arguments suggest that possible gains from South-South integration are significantly lower than from North-South or unilateral integration.

Assuming that a country group could be identified which offers the opportunity for gains from integration, the advantage of alternative strategies in terms of efficiency depends on the effects on imports and exports respectively. On the import side, a complete, unilateral liberalization is superior to all regional integration strategies with respect to economic welfare, the difference being equal to the trade diversion effect [Jovanovic, 1992, p. 20ff.; Hiemenz, Langhammer, 1989]. Among the regional integration alternatives, welfare effects are likely to be superior in North-South integration because North-South integration allows for substantial gains from inter-industry specialization whereas South-South integration is likely to maximize trade diversion by impeding such specialization.

Unfortunately, the reverse order appears with respect to vested interests. A complete, unilateral liberalization eliminates both fiscal revenue from taxing imports and trade diversion effects. The former effect imposes a pressure on the government to switch from international taxation which is important for low income countries [Tanzi, 1990] to domestic taxation and limits the discretionary power of politicians and bureaucrats. The latter effect forces the producers of import-substitutes to improve efficiency or to switch to other products. Hence,

unilateral liberalization is heavily opposed by the government and the producers of import-substituting goods.

According to the extended interest-group approach to the determinants of protection in developing countries [Amelung, 1987; 1989], this is a rather forceful coalition. First, the demand for protection is high because capital owners reap high benefits if they invest in capital intensive production which needs protection against products from high income countries. Second, the demand for protection is easy to organize because capital is scarce and highly concentrated, the capital owners living in the cities where they have good access to the government. Third, the high demand for protection meets supply because of vested interests on the side of the government. Hence, the resistance against integration can be expected to be significantly lower for South-South integration than for North-South or unilateral integration.

The opposition against an "import-biased" coalition has to come from exporters because consumers are hardly to be organized. The position of exporters could be strengthened by an increased access to foreign markets. This may give an advantage to regional integration over unilateral integration. Staying outside a closed trading bloc, i.e. a customs union with a high external tariff, can become costly due to the trade diversion effect [de Melo et al., 1993, p. 175]. If relevant trading partners of a country which stays outside are in the customs union, the possibility to increase trade with other (non-partner) countries does not necessarily compensate for the decrease in trade with partner countries.

However, the trading bloc argument constitutes an advantage of North-South rather than South-South integration over unilateral integration. It is reasonable to assume that exporters in low income countries benefit more from market access to high income countries' markets than from market access to other low income countries' markets. The trading bloc argument also stresses the second best character of regional integration. Only if trade barriers erected by a customs union are significant it becomes worthwhile to join it both for politico-economic and welfare considerations.[5]

The discussion of static effects of goods markets integration suggests that

- unilateral integration is clearly superior to regional integration in the absence of trading blocs but suffers from the lack of access to foreign

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[5] On EU and NAFTA trade regimes and on effects on non-partner countries, see Gundlach [1993], and Langhammer [1992a; 1992b; 1993]. It has to be acknowledged that part of the incentives to join North-South integration also stem from income redistribution in favour of low income members.

markets and from the resistance of pressure groups interested in import protection,

-   fiscal reforms may overcome political resistance by reducing the importance of trade taxation and public ownership,

-   regional integration may overcome political resistance by providing market access, and strengthening the position of exporters,

-   North-South integration is superior to South-South integration because of lower transaction cost and higher gains from integration outweighing political resistance.

All in all, South-South integration is hardly a viable option. The relevant choice is between North-South and unilateral integration. The advantage of North-South integration stems from protectionist attitudes of high income countries.

2. Dynamic Effects of Goods Markets Integration

From a purely economic point of view, possible gains from integration crucially depend on the dynamics of integration. Static effects only set the starting conditions which will provoke economic adjustment. Economic adjustment, in turn, will affect possible gains from integration. There are basically two categories of integration effects which can be expected to influence the gains from integration in a dynamic perspective: market size and external effects. The relevant question for low income countries is which integration offers the largest potential to reap dynamic gains, i.e. to catch up with high income countries.

a. Overall and Relative Market Size

A first argument in favour of dynamic gains from integration due to an increase of the overall market size is related to import substitution. Chapter II.1. gave the positive explanation for import substitution to occur. However, import substitution is always justified by normative arguments. Especially in developing countries, industrialization via import substituting strategies figured high on the policy agenda and provided a main argument in favour of South-South integration [Bhagwati, 1993]. The basic argument is that, compared to industrialization on a domestic basis, regional integration lowers the opportunity costs of import substitution. When domestic markets prove to be too small to allow efficient import substitution as the starting point of industrialization, the formation of a regional market is seen as a way out of this impasse. In economic terms, industrialization is seen as a rational social choice. Countries are willing to bear the costs of income foregone by not importing from the cheapest available source or by specializing in activities in which they do not have

comparative advantages. Given this social preference for industrialization anything that lowers the costs of additional industrial capacity increases welfare and contributes to economic development [Johnson, 1967, pp. 208-210]. The larger the social preference and the potential for industrialization is, the less important becomes the static Vinerian welfare-reducing effect of trade diversion for countries entering a regional grouping.

However, a problem associated with regional integration is that opening the domestic market to industrial imports from member countries entails a sacrifice of domestic industrial capacity foregone [Langhammer, Hiemenz, 1990, pp. 6-7]. Only if intra-union comparative advantages exist within the industrial sector rather than between the industrial and non-industrial sectors, each partner may gain compared to the alternative of national industrialization based on import substitution. Otherwise, countries may see their social preferences violated even if they would gain more in terms of income or expansion of nonindustrial activities than they lose in the industrial sector. Additionally, the preference for industrialization is a second-best objective and can, therefore, provoke distributional conflicts among partners. As a result, the chances that regional integration schemes help low income countries to develop their industrial base via import substitution are rather low. More generally, export orientation has been shown to be superior to import substitution as a development strategy. Export orientation means that the system of incentives is neutral with respect to sales in domestic or in world markets [Hiemenz, Langhammer, 1989, p. 106]. This requires unilateral integration and not a selective elimination of tariffs as is the case in a customs union.[6]

A second class of arguments refers to efficiency and competition rather than to protection [Emerson et al., 1988, Part D]. First, production becomes more efficient, if there are economies of scale internal to a firm and a domestic market which is too small to exploit these scale economies. Second, market integration also increases the number of competitors. Hence, dynamic gains from market integration are to be expected if domestic markets have been small enough to establish natural monopolies or oligopolistic competition and if the integrated market is large enough to establish a competitive market. Third, the Heckscher-Ohlin model [Siebert, 1991a, pp. 53-78] predicts that gains from specialization are high when relatively labour abundant countries become integrated with relatively capital abundant countries. All three effects lead to a higher efficiency

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[6] An argument closely related to industrialization via import substitution is the training ground or infant industry argument (see, e.g., Jaber [1970]). It suffers from the same drawbacks and fails to give an answer why import substituting industries need more training than others.

of production–which implies a static short-run increase of income due to the higher productivity of a given capital stock and a medium-run growth effect due to the incentive to increase the capital stock because of the higher productivity [see Baldwin, 1989].

Generally, small and labour abundant low income countries should be able to reap substantial benefits from market integration with large and capital abundant high income countries. In this case the increase in market size, competitors and specialization is especially pronounced for the low income country. Therefore, from the point of view of the low income countries, market integration with high income countries seems to be a perfect development strategy and the chances to catch up by South-South integration are rather bleak. As was the case with respect to static effects, the optimal choice is between unilateral and North-South integration and depends on market size. Again, North-South integration is only optimal if significant barriers to market access exist in the case of unilateral integration.

However, recent theoretical contributions to economic geography point out that the honeymoon of North-South or unilateral integration may at least be clouded by relative market size effects. Models of economic geography [Krugman, 1991; 1992] predict the concentration of production in large countries. They assume that a single homogenous agricultural product is produced with constant returns to scale, while manufacturing is a composite of product varieties and involves economies of scale, with a fixed cost for any variety produced at any given location. Transportation costs of manufactured goods are assumed to increase with distance. Workers move towards locations that offer higher real wages.

Though these extreme assumptions may be unrealistic, the driving forces underlying models of economic geography are plausible. First, economies of scale due to fixed costs of production provide an incentive to concentrate production because of cost advantages. Second, concentration is less likely when transaction costs are high, because increasing transaction costs tend to outweigh the cost advantage of concentration. Hence, market integration will lead to more concentration because of the reduction of transaction costs by the elimination of internal tariffs. Better forward and backward linkages then provide incentives for manufacturing to locate near large rather than near small markets. As a consequence, high income countries with larger markets would have an advantage when market integration starts. The concentration of production would even accentuate this advantage: larger markets would increase whereas smaller markets would decrease.

However, some qualifications are in order. First, empirical evidence does not support a strong impact of internal economies of scale [see, e.g., Caballero, Lyons, 1990]. Second, concentration decreases if product differentiation is significant as is the case with intraindustry trade. Third, congestion costs may outweigh concentration benefits. Fourth, that countries with small markets may not have a comparative advantage in large scale production implies that they should concentrate on small scale production in order to reap the dynamic gains from integration. Fifth, concentration only occurs as long as economies of scale *could* be exploited in a situation of oligopolistic competition. Increasing competition in an integrated market forces producers to move down the average cost curve to its minimum where average costs equal marginal costs, i.e. economies of scale cease to exist [Baldwin, 1989].

All in all, market size is an argument in favour of either North-South or unilateral integration which enlarge market size significantly and improve competition most. To the contrary, distributional conflicts are to be expected in the case of South-South integration motivated by import-substitution strategies. Low income countries clearly gain most by joining large markets with low external barriers and by specializing according to their comparative advantages. In this case, catching-up rather than falling behind is to be expected.

b.   Externalities of Physical and Human Capital

Assuming efficient specialization, recent models of endogenous growth point to remaining chances and risks due to external effects of the accumulation of physical and human capital. They show that convergence of income levels is not necessarily the outcome of market integration. On the one hand, models with increasing returns predict higher growth and convergence. On the other hand, human capital models predict divergence [Tajoli, 1991; Stolpe, 1992].

Increasing returns external to the individual firm have been introduced in growth models by Romer [1986]. Knowledge is accumulated by firms as an externality of the process of capital accumulation, i.e. each firm's investment is a positive externality for all the others. Rivera-Batiz and Romer [1991] show that market integration leads to higher growth in all participating countries. This result occurs either because of externalities in the R & D sector and an increased flow of ideas or because of increasing returns in the aggregate production function due to R & D and an increased flow of goods allowing for a better exploitation of ideas in a larger market.

In the specification of Grossman and Helpman [1991], innovation is driven by R & D, an activity that firms pursue in order to develop differentiated intermediate

goods. The production of intermediaries has increasing returns (internal to the firm). When trade barriers decline due to market integration the usual neo-classical result applies. Assuming that the low income countries import human capital intensive goods, the Stolper-Samuelson theorem implies that free trade will lower the cost of human capital for this group of countries. If the costs of human capital decrease, the costs of R & D decrease, the innovation rate increases and so will the output growth rate. Because the opposite effect will occur in high income countries, the convergence effects of market integration will be strengthened.

In human capital models [Lucas, 1988], the input labour is substituted by effective labour, i.e. the amount of work done per unit of time. The effective labour can increase due to the accumulation of human capital defined as working skills. If low income countries with a relatively low endowment with human capital and high income countries with relatively high endowment with human capital integrate, low income countries will specialize according to the comparative advantage, i.e. in less human capital intensive sectors. If human capital is accumulated by learning-by-doing, the effect of integration will be to lower the growth rate in low income countries because production decreases in sectors where human capital accumulation by training on the job is high.

An alternative specification of human capital models assumes that workers acquire skills by devoting time to accumulate human capital, i.e. they go to school. In this case, investment in education can change the comparative advantage of a country. Assuming that human capital accumulation by learning in school and by training on the job are complementary [Hiemenz, Nunnenkamp et al., 1991, p. 53], investment in education constitutes a strategy for catching up. It attracts production activities which are more human capital intensive, creates positive externalities, and fosters economic growth.

Generally, converging and diverging forces may be accentuated by increased trade due to the integration of goods markets and catching up requires to built up human capital and to attract private investment. To the extent that human capital and private physical capital accumulation need complementary public investment, low income countries may face a problem. Their ability to invest may be significantly constrained by the decline of trade taxation. Therefore, the integration of goods markets increases the pressure for fiscal reforms especially for low income countries. Trade taxation has to be substituted by other taxes, e.g., by taxing consumers who benefit from the integration of goods markets. Additionally, government expenditure has to concentrate on efficiency enhancing public investment. If such fiscal reforms take place, low income

countries integrating with high income countries improve their chances for catching up; otherwise, they run the risk of falling further behind.

To sum up, the discussion of dynamic effects of integration suggests the following conclusions:

- To cushion in South-South integration does not pay in a dynamic perspective. Industrialization via import substitution is a misleading strategy and export promotion suffers from − at best − modest increases in market size and competition.

- Integration with high income countries is superior to South-South integration. It contains the chance to catch up. This chance is superior in large, open integration schemes. It can be improved by internal adjustment efforts with respect to the specialization of production according to comparative advantages and with respect to the structure of fiscal revenue and expenditure.

- Given the willingness and the ability for internal reforms, the superiority of either North-South or unilateral integration remains − as was the case for static effects − an empirical question. Generally, low income countries are well advised to go for the largest and the most competitive markets.

3. Relevance for Low Income Countries

Low gains from South-South integration explain why integration policies in such schemes were implemented half-heartedly and often in an inconsistent fashion, were abolished after a relatively short period of time, or were neutralized by new, mostly non-tariff barriers [Langhammer, Hiemenz, 1990, p. 59].

One of the most telling examples in this respect is the Preferential Trade Area of Eastern and Southern African States (PTA; see Langhammer et al., 1990]. The target of the PTA was a free trade area which has never been achieved. Even the implementation of effective trade preferences failed. Either preferences have never been granted or countries have vetoed against a product to appear on the "common list" of products for which preferences have to be granted. Additionally, preferences have been differentiated according to stages of production and local content and prohibitive non-tariff barriers have never been reduced.

The failure of PTA is hardly surprising. First, it lacks a leading economy strong enough to create gains from integration for the others. The most important trading partners of PTA countries are industrialized countries. Even Kenya and

Zimbabwe, though relatively advanced, are too weak[7] and South Africa's new role has still to be defined. Second, the countries are stuck in import substitution strategies and distributional conflicts. Third, transaction costs are often prohibitive. This holds for the physical infrastructure as well as for the diffusion of information and the institutional framework.

The case of Argentina's unilateral integration since the implementation of economic reforms in April 1991 shows, that there is a viable alternative to South-South integration. There are − at least − two remarkable aspects of the Argentine reform [Schweickert, 1994a]. The starting conditions have been extremely unfavourable: hyperinflation, unsustainable fiscal deficits, stagnating or declining real income, low if any credibility of the government, and a de-facto closed economy. Nevertheless, real and fiscal adjustment was radical and allowed for a nearly complete opening of the economy: tariff barriers were reduced, non-tariff barriers were eliminated, the currency became fully convertible, domestic regulations were adjusted towards world market standards, public-owned enterprises were privatized even in sensitive sectors, an operational surplus of the fiscal budget was achieved by a tax reform, and internal as well as external debt was consolidated and serviced.

Although unilateral integration seems to be sustainable without any preferential market access, Argentina tries to enlarge its market. As a first step, Argentina joined MERCOSUR, a regional integration scheme which allows preferential access to the markets of Paraguay, Uruguay, and − most importantly − Brazil. On paper, the ultimate aim of MERCOSUR is a customs union which, however, is unlikely to emerge. Brazil seems to continue macroeconomic mismanagement and protectionist regulations of goods and capital markets and Argentina will not give up the gains from unilateral integration. Additionally, there are comments by US officials that Argentina could be incorporated in NAFTA. In line with the theoretical arguments on North-South vs. South-South integration, the Argentine government reconsiders its trade policy because a close link to Brazil could impede an eventual entry into NAFTA [EIU, 1993, No. 4, p. 22]. Because NAFTA is a free trade area, Argentina could achieve a maximum market size and competitive pressure by joining NAFTA and by maintaining unilateral liberalization with all other countries.

The newly emerging market economies in Central and Eastern Europe had to decide between unilateral integration and North-South integration in a customs union. After having liberalized their economies at the beginning of the 1990s

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[7]   Additionally, they are unwilling to open up their markets for the others.

[EBRD, 1993, p. 33ff.], Poland, Hungary, the former Czechoslovakia, Romania, and Bulgaria signed association agreements with the former EC. Therefore, significant potential gains from unilateral integration will be lost for these countries unless the EU lowers its external barriers.

The widening of the EU and of NAFTA will especially hurt low income countries which are not offered access to these North-South integration schemes · [Langhammer, 1992a; b]. There are three basic solutions to this problem. First, from a normative point of view, GATT rules have to be changed [Nunnenkamp, 1993]. Either regional integration schemes will have to open up for all countries independent of their geographical location or non-partner countries will have to be compensated. Second, and also from a normative point of view, North-South integration schemes should decline external trade barriers.

These two solutions, however, suffer from politico-economic constraints. At least to a significant extent, regional integration schemes are motivated by creating trade diversion, the gains from which should be distributed among partner countries. Paying compensation and opening up regional integration schemes eliminate such gains. It could be hardly assumed that, e.g., the EU agrees to strip itself of its own attractiveness.

More promising than waiting for trading blocs to consider the welfare of non-partner countries is to increase the pressure for market access. The example of Argentina clearly demonstrates the superiority of the following sequencing: unilateral liberalization first in order to increase the attractiveness as a trading partner; negotiate for increased market access then; prefer free trade arrears to customs unions. The strategy of a large number of low income countries seems to be completely different. They try to sustain protectionism and negotiate for preferential market access first. Due to the weak negotiating position, it is rational that high income countries do not grant effective preferences. Hence, these low income countries have to blame themselves in the first place for forgiving the chances which integration offers.

III. Integration Deepening between Low and High Income Countries

The following analysis of integration deepening assumes that the arguments put forward in Section II of this paper have excluded South-South integration as a viable strategy. Hence, integration deepening has to be discussed in the context of unilateral and North-South integration. With respect to the latter, the discussion has to focus on the European case where a full-fledged integration between high and low income countries seems to be possible. At least the normative question is relevant whether or not newly emerging market economies

as well as developing countries already included in the EU (Portugal and Greece) should press for different pace and scope of European integration for themselves. Another question to be asked is whether integration deepening changes the relative advantages of unilateral and North-South integration respectively.

1. Factor Markets Integration

Factor markets integration means the free flow of people and capital. With respect to the former, the mobility of people between North and South is generally seen as a problem because migration from South to North bears significant social costs in all countries involved (for an overview, see, e.g., Siebert [1993a]). It can safely be assumed that the motivation of the EU and the US to negotiate integration schemes with low income countries stems to a great deal from the intention to reduce the incentives for immigration.

With respect to the mobility of capital, a closely integrated world capital market already exists implying a high mobility of financial capital. But the free flow of capital also includes the non-discriminatory treatment of production according to ownership, i.e. the unrestricted allowance of foreign direct investment (fdi). It is in this area where significant impediments to the flow of capital still exist (see e.g. Agarwal et al. [1991], and Greenaway [1993]).

a. Stabilizing or Destabilizing?

The hesitation to encourage the flow of production factors may be motivated by the fear that the real equilibrium becomes less stable or that it changes in favour of more high income countries. This can be demonstrated by using Figure 1. It shows the factor price frontiers — the transformation curves drawn in the factor price space[8] — for a low income (FPF_D) and a high income country (FPF_I) (see Siebert [1993b] p. 10 on the case of German unification). As before the low income country is assumed to be small relative to the high income country. Additionally, production is more efficient in the high income country. Free trade equalizes relative factor prices, i.e. the low income country moves to GG_{DT} and the high income country to GG_{IT}. As can be seen in Figure 1, the absolute factor prices are higher in the high income country due to the technological advantage. If capital mobility is allowed, capital flows to the high income country, the low income country moves along FPF_D to GG_{DC} and r_i^* becomes the common equilibrium real interest rate.

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8 l is the real wage and r the real interest rate.

Figure 1 - Market Integration and Factor Prices
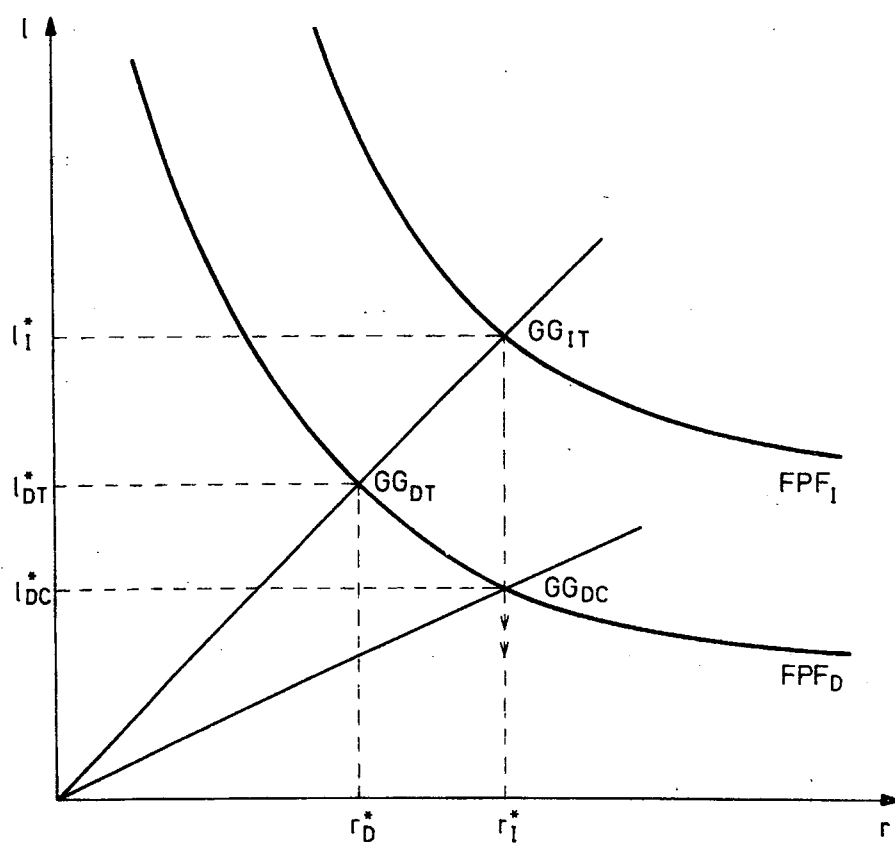
Three consequences of such a scenario are relevant for low income countries. First, GG_{DC} is not a stable equilibrium. At GG_{DC} capital has become relatively more expensive in the low income country. Free trade provides the incentive to specialize in labour-intensive production which lowers the price of capital relative to labour. A lower price of capital, however, implies that capital flows out of the low income country. Free trade pulls the economy to GG_{DT} and capital mobility pulls the economy to GG_{DC} leading to a permanent outflow of capital. Capital flows in the 'wrong' direction, i.e. to the relatively capital abundant country.[9]

Second, the incentives to migrate are higher in the case of capital mobility. As can be seen in Figure 1, the gap in real wages between the low and the high income country has increased to $l_f^* - l_{DC}^*$ compared to $l_f^* - l_{DT}^*$ in the case of free trade without capital mobility. Because migration sets in if differences in income become sufficiently large, capital mobility might induce migration and a loss of human capital. In the same way as free trade, labour mobility would pull the economy back to GG_{DT}. The result would be an outflow of labour and capital.

Third, if capital accumulation has external effects or human capital adds to an economy's capital stock, the low income country would permanently lose competitiveness. In Figure 1, FPF_b shifts to the left and GG_{DC} moves downwards. The difference in real wages increases, the outflow of human capital increases, FPF_b shifts further to the left and so on.

However, Figure 1 assumes that productivity is determined only by technology. As discussed recently [Siebert, Koop, 1993; Sinn, 1993], institutional competition can provide a countervailing force. First, it increases overall efficiency because it allows countries to take measures according to their individual preferences. Additionally, it enhances economic growth because governments have to react to changes in their environment. This increases the incentives to find better institutional arrangements and minimizes the cost of finding the best institutional arrangement by letting the market decide [Hayek, 1968].

Second, from the low income country perspective, institutional competition improves the chances to outweigh technological disadvantages. Diverging institutional arrangements with respect to regulations (regarding health care, social security, environmental protection etc.) produce different costs. However, assuming that, e.g., environmental effects are country specific, different regulations are an optimal solution if preferences for environmental protection

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[9] On this point, see also Lucas [1990].

are different [Siebert, 1991b]. The loss in competitiveness of countries with stiffer environmental regulations is then the price to be paid for a higher consumption of the environmental good. Most importantly, less stiff regulations constitute a chance for low income countries to attract investment.[10] In terms of Figure 1, institutional competition can shift FPF_D to the right of FPF_i leading to capital inflows. If those inflows take place in the form of (non-discriminated) fdi, the low income country could further improve its competitive position by importing technology and by improving human capital due to learning on the job.

Full capital mobility is a necessary and sufficient precondition for institutional competition. Firms and investors have to be allowed to choose the best location (see Sinn [1992]). The case for the mobility of people is less clearcut. It may be argued that consumers and workers need an additional way of voting by feet in order to force governments to work more efficiently [Brennan, Buchanan, 1980; Hirschman, 1970]. But, contrary to investors and firms, they have the option to vote in elections and with capital mobility the negative impact of inefficient policies are more likely to show up immediately, i.e. before the next election. This makes voting a more effective instrument to control governments. Hence, mobility of people has limited potential gains. It has also significantly higher (private and social) costs compared to capital flows.

Additionally, migration is not an efficient instrument to control governments because of hysteresis effects.[11] Hysteresis effects result from sunk costs and the uncertainty related with the decision to move. As a consequence, large changes in the economic conditions are necessary to induce migration and the reversal of economic conditions does not necessarily reverse migration. Thus, migration is not flexible enough to control government policies.

The free flow of people may also overstrain tax reform capacity of low income countries. On the one hand, capital as well as labour mobility limit the potential for raising revenues because a mobile tax base can not be taxed [Siebert, Koop, 1993, p. 6]. On the other hand, funds have to be raised for public investment in a physical and institutional infrastructure attractive for foreign investors. Therefore, the tax base should be maintained as far as possible by allowing for

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[10] Assuming that the income level is positively correlated to the preference for the environmental good, this is an efficient solution.

[11] See Siebert [1993b] on the economics of migration and Dixit [1992] on hysteresis effects.

the elimination of trade and capital taxation[12] and by maintaining the possibility of taxing people by limiting migration.

All in all, the integration of factor markets provides risks and chances for low income countries. The risks depend on the ability to reform taxation and fiscal spending. Therefore, migration should at least not be encouraged. The chances depend on the possibility to attract foreign investors via institutional competition.

b. Relevance for Low Income Countries

With respect to regional integration two different strategies can be identified. On the one hand, Mexico removed restrictions on fdi in order to attract production lines in NAFTA [Langhammer, 1992b]. On the other hand, the association agreements between the EU and newly emerging market economies contain significant grace periods for the dismantling of fdi regulations [Langhammer, 1992a]. According to the above argumentation, the Mexican strategy is clearly superior.

Most interestingly, the institutional competition argument tends to improve the attractiveness of unilateral integration compared to North-South integration. While, e.g., Argentina is free to improve integration effects by providing conditions for investment adequate to attract fdi and to encourage domestic investment, countries integrating into the EU will have to adjust to common regulations.[13] It is reasonable to assume that such a harmonization in the EU is not a reflection of economic efficiency considerations but rather a reflection of producers in high income countries demanding for a level playing field in order to avoid institutional competition [Siebert, 1991]. Moreover, EU politicians and bureaucrats tend to favour the harmonization of regulations because they derive utility from the exercise of power related to the implementation of harmonized regulations [Vaubel, 1991, 1992; Starbatty, 1993]. Clearly, any such harmonization of regulations hurts low income countries in the first place and reduces the advantage of North-South integration from their perspective.

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[12] The elimination of capital taxation does not imply that no price for public services is charged which - of cause - has to be equal to its marginal benefit.

[13] Tough the Casis-de-Dijon ruling allow for individual regulations, the Maastricht Treaty laid the ground for a common industrial and social policy restricting institutional competition (see e.g., Laaser, Soltwedel et al. [1993] and Schmieding [1992a]).

2. Monetary Integration

Monetary integration is an important issue both in unilateral and regional integration. Unilateral monetary integration is complete in a currency board regime where the exchange rate against an anchor currency is fixed, the monetary base is fully covered by foreign exchange, and the Central Bank buys and sells any amount of foreign exchange offered or demanded. The mechanics of a currency board regime are exactly those of a monetary union, the highest form of regional monetary integration. A country's money supply is determined by the changes of the foreign reserve position. Hence, a currency board simulates the situation of having a monetary union.[14]

From the low income country perspective, the main argument in favour of monetary integration with high income countries is to fight high and/or persistent inflation by improving the credibility of stabilization.[15] [16] The basic idea is that a nominal anchor in the form of a fixed exchange rate should import the anti-inflationary reputation of a stable currency by tying the hands of the own monetary authorities. If discretionary policy is ruled out and monetary policy is determined by the foreign Central Bank, the credibility of stabilization would improve, private agents would adjust at once, and inflation would decrease to and remain at the level of the stable currency. If valid, the credibility argument would constitute a reason for low income countries to implement a currency board with a fixed exchange rate against the currency of a stable high income country or to join a monetary union with a stable high income country.

However, the following analysis shows that exchange rate based stabilization needs rather than produces credibility. Moreover, if demanding preconditions are not fulfilled monetary integration is likely even to endanger goods markets integration, i.e. it distorts rather than deepens integration.

a.   Stabilization vs. Real Adjustment

To see how a fixed exchange rate *can* stabilize an economy, assume that the economy is in macroeconomic equilibrium and net capital flows are zero. The

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[14] The most important differences are, first, the physical existence of an own money in a currency board regime which may give rise to currency speculation and, second, that a currency board has no leverage with respect to the monetary policy of the foreign Central Bank.

[15] Again, South-South integration can be ruled out as a viable option. First, developed countries have - on average - a higher reputation for stability. Second, integration with developed countries saves more transaction costs.

[16] Another one is the saving of transaction costs which is generally accepted [Willms, 1992, p. 189] but not proved by empirical evidence, e.g., by a negative correlation between exchange rate variability and the volume of trade [Krugman, 1989, p. 68].

difference between domestic and foreign inflation is compensated for by nominal devaluation so that the real exchange rate is constant, i.e. the real exchange rate is in equilibrium but inflation is significantly higher than abroad. If the exchange rate is fixed in such a situation, inflation decreases immediately because the price increases for traded goods are curbed by world market conditions. But ongoing inflation for non-traded goods will lead to an immediate real appreciation.

Real appreciation creates an excess demand for traded goods and an excess supply of non-traded goods. This is because traded goods become relatively cheaper and demand shifts from non-traded to traded goods. Excess demand for traded goods implies a trade deficit, an outflow of foreign reserves, and – with a passive monetary policy – a monetary contraction.[17] As a consequence absorption decreases, the demand for traded goods declines and the trade imbalance is reduced. But the decrease in absorption further increases the excess supply of non-traded goods. This exerts a pressure to reduce the prices of non-traded goods. Domestic inflation must be even lower than abroad in order to remove the real overvaluation and the excess supply of non-traded goods caused by the initial real appreciation.[18]

A necessary precondition for private agents to adjust prices is that they expect the monetary contraction to occur. If this is not the case, ongoing inflation, growing real overvaluation, and increasing internal and external imbalances will end the stabilization program soon. Therefore, the credibility of the monetary contraction becomes a basic precondition for the flexibility of prices and for the success of the exchange rate based stabilization.[19] Problems with its credibility result from two macroeconomic constraints: the government budget[20] and employment [Schweickert, 1993b].

The need to finance the government budget may constrain the possibility of a monetary contraction in low income countries because the collection of the

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[17] In the following, monetary contraction means a decreasing real money supply. Correspondingly, decreasing domestic prices mean a lower difference between inflation at home and abroad.

[18] In the absence of real shocks, the equilibrium of the real exchange rate remains constant and the actual real exchange rate has to return to its initial level.

[19] Contrary to a stabilization program with flexible exchange rates, the extent of the monetary contraction is unknown at the beginning of the program. This makes the credibility of the monetary contraction a challenging precondition in a fixed exchange rate regime.On the advantages of stabilization with flexible exchange rates, see Schweickert [1993a; c].

[20] Because only a currency board regime and a monetary union are considered, another relevant macroeconomic constraint - foreign exchange reserves - could be neglected. On this point, see the literature on balance-of-payments crises summarized by Aghevli and Montiel [1991, pp. 229ff.].

inflation tax and borrowing on thin domestic capital markets play a significant role in financing government expenditure. Therefore, a monetary contraction needs fiscal discipline,[21] i.e. expenditure has to be reduced and/or alternative taxes have to be raised.[22] Otherwise growing pressure on the central bank to increase the money supply would be expected by rational private agents. Hence prices would not be adjusted.

If the monetary contraction is possible, the question arises, if it actually occurs. The temporary fall in demand provides strong incentives for the authorities to change the program and to avoid temporary unemployment via a monetary expansion. This means that the announcement of a fixed exchange rate is time-inconsistent and private agents have an incentive not to adjust prices but to wait for the policy switch.[23]

In the case that private agents judge macroeconomic constraints not to be relevant, monetary contraction is credible and guarantees a pressure to reduce the prices of non-traded goods. If these prices are actually adjusted depends on the price setting behaviour in the real sphere of the economy. The fall of non-traded goods prices will not occur in the presence of indexation and inflationary inertia [Edwards, 1993, pp. 5-10] and a low level of competition. In this case, the monetary contraction will lead to higher unemployment rather than to a real exchange rate adjustment.

The adjustment towards a new equilibrium becomes easier if the country is able to attract capital inflows. Large capital inflows finance emerging trade deficits and increase foreign exchange reserves. Hence, the money supply grows and the prices for non-traded goods do not have to be adjusted downwards. However, such an equilibrium may not be sustainable. First, capital inflows are of a temporary nature at least to some extent. Second, the country may experience a negative terms-of-trade shock. Third, if the exchange rate is fixed against a

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[21] Of course, the collection of the inflation tax could improve because of an increasing demand for money. This implies that a monetary contraction, i.e. a decrease in real cash balances, does not occur at all. However, the question addressed here is if a monetary contraction could be sustained.

[22] This has not only implications for sustainability but for optimality as well. If the common or dominating Central Bank has a zero inflation target, the inflation tax would be completely eliminated. The literature on the optimal inflation tax (see, e.g., Végh [1989] and Edwards, Tabellini [1991]) shows that a positive inflation tax rate is efficient if the distortions imposed by other taxes are considered and - especially relevant for developing countries - if the costs of levying alternative taxes are high.

[23] See Funke [1993] for an application of time-inconsistency arguments for reform strategies in developing and Eastern European countries.

single currency, e.g. the US$, an appreciation of the US$ against other relevant currencies would imply a real appreciation for the domestic currency as well.

All these shocks have qualitatively the same implication for the economy. The real exchange rate becomes overvalued, the trade deficit has to be financed by an outflow of foreign exchange reserves, and the demand for non-traded goods falls short of supply. This means that all the problems described above for the case of stabilization without capital inflows emerge. Moreover, the problems are even more pronounced due to the initial expansion. This is why the reversal of capital flows typically marks the end of fixed exchange rate regimes. Monetary contraction is not sustained and a devaluation crisis emerges [Guidotti, Végh, 1992].

The chances to sustain a fixed exchange rate in the face of an overvalued exchange rate could be improved by complementary liberalization policies.[24] However, the conclusions are different for the liberalization of goods and capital markets.

The most prominent issues in the liberalization of goods markets are trade liberalization and privatization of state-owned enterprises. The arguments against a simultaneous implementation of trade liberalization and macroeconomic reform claim that such a policy exceeds the capacity for real adjustment. There are, however, strong arguments in favour of a simultaneous implementation [Ize, 1990]. First, the production of exports is encouraged by lower prices for imported inputs reducing trade imbalances and the need for real devaluation. Second, intensified competition raises the efficiency of domestic production, allows to reduce prices, and, thus, speeds up real devaluation. Hence, goods markets integration is an important precondition for the sustainability of a fixed exchange rate. In the same vein, the privatization of public-owned enterprises – especially if they belong to the non-traded goods sector – makes prices more flexible and speeds up real exchange rate adjustment if an appropriate regulation provides incentives for competition and enhances efficiency in areas where competition is not possible.

With respect to capital flows, the problem is to measure the temperature of capital flows [Dornbusch, 1983; McKinnon, 1984].[25] The flow of cold money, i.e. long-term capital, is difficult to avoid in the case of capital outflows and is

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[24] See Edwards [1989] for an overview over the debate on the sequencing of macroeconomic reforms and liberalization policies.

[25] It is important to distinguish this argument from the one made above for a full capital mobility which has focused a growth perspectives rather than a macroeconomic stability.

highly welcome in the case of capital inflows because it reduces the need for real devaluation. The flow of hot money, i.e. speculative, short-term capital, destabilizes real exchange rate adjustment. Therefore, exchange controls are advocated for the flow of hot money in the first place.[26] [27] It can be expected that private agents will adjust quicker to changes in relative prices if they regard them as more stable. Moreover, a higher stability of real exchange rate adjustment improves investment conditions and growth prospects [Rodrik, 1989, p. 19].[28]

Financial market regulations such as fixed nominal interest rates negatively affect real exchange rate devaluation. A contraction of loanable funds may occur leading to or expanding a demand surplus if interest rates are not allowed to rise in order to mobilize private savings and to relax credit constraints [Corsepius, 1989; McKinnon, 1973, pp. 84 ff.]. By relaxing credit constraints, a liberalization of domestic capital markets improves real adjustment to overvaluation in two respects. First, efficiency enhancing investment in the production of non-tradables eases the decline of prices for these products. Hence a real devaluation will be quicker and temporary unemployment could be avoided. Second, investment in the restructuring of domestic supply in favour of tradable goods reduces the need for real devaluation.

The arguments on the appropriate sequencing of real exchange rate adjustment and liberalization policies show that liberalization of goods markets, of the domestic capital market, and of long-term capital flows can be expected to improve rather than to overstrain the capacity for real adjustment. However, the elimination of an independent monetary policy and the implementation of liberalization policies may overstrain the capacity for fiscal adjustment. Trade liberalization declines trade tax revenues; privatization declines the possibility for implicit taxation via public enterprises; free capital flows exclude the collection of the inflation tax via foreign exchange premia; the liberalization of the domestic capital market increases the cost of borrowing. These effects stress the need for fiscal reform in order to sustain fiscal control over the economy and to improve the credibility of a fixed exchange rate.

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[26] The effects of speculation can be expected to differ according to the exchange rate regime adopted. But both fixed and flexible exchange rate systems are vulnerable to destabilizing speculation.

[27] It is of course possible to circumvent capital controls by overinvoicing of imports and underinvoicing of exports. But the controls raise the costs and limit the extent of currency speculation.

[28] Generally, overvaluation cannot be avoided or reduced by strict capital controls because it is due to inconsistent domestic policies and distortions in capital and goods markets in the first place. However, the relevant question here is whether or not free capital movements support the real devaluation policy which tries to remove such inconsistencies.

The following conclusions can be drawn from the theoretical discussion of exchange rate based stabilization and real devaluation:

- the preconditions for sustaining an exchange rate base stabilization are rather demanding: the independence of monetary policy from macroeconomic constraints – fiscal balance, unemployment – and a high flexibility of domestic prices;

- the liberalization of goods and capital markets – with the exception of short-term capital flows – helps macroeconomic reform because it improves adjustment capacity;

- fiscal reform is of utmost importance because fiscal constraints limit both the flexibility of monetary policy and the liberalization of goods and capital markets which help maroeconomic reform.

- if domestic prices and domestic supply responses to real shocks are rather sluggish – which can not be ruled out even under favourable circumstances – a fixed exchange rate distorts relative price signals, the efficient allocation of resources, and, hence, goods markets integration.

b. Relevance for Low Income Countries

The currency board type implemented in Argentina shows how successful unilateral monetary integration can be [Schweickert, 1994a]. Starting with hyperinflation in 1990, annual consumer price inflation came down to 5.2 per cent at the end of March 1994. Capital flows changed their direction and Argentina has received substantial net inflows since 1992. The monetary base has more than tripled in real terms and market driven expansion led to high real growth rates after years of stagnation or decline. This success is due to outstanding adjustment efforts with respect to fiscal reforms and the liberalization of goods and capital markets, i.e. Argentina's unilateral integration into the world economy.

Argentina's success gives interesting conclusions for newly emerging market economies for which exchange rate based stabilization has been proposed recently [Bofinger, 1991; Schmieding, 1992b; Hofmann, Sell, 1993] and for low income countries like Portugal and Greece which have a chance to join the European Monetary Union (EMU). First, these countries should be able and willing to put forward adjustment measures comparable to those in Argentina. Second, if strong adjustment efforts are possible, the convergence indicators laid down in the Maastricht Treaty for joining EMU make no sense. Argentina would have met non of these indicators. Third, European developing countries willing

to implement exchange rate based stabilization do not have to wait for EMU. They can go for a currency board regime in the meanwhile.

However, the experience of Chile at the beginning of the 1980s clearly suggests that at least in the medium-run a more flexible exchange rate is adequate [Schweickert, 1994b]. The reason for the break-down of the fixed exchange rate in Chile was that the implications of the debt crisis required a huge real devaluation. Real devaluation would have required a monetary contraction large enough to squeeze inflation significantly below the US level which might have implied a disinflationary process. A situation which was not sustainable and provoked a balance-of-payments crisis even though Chile has undergone a fiscal reform and a deregulation of the economy comparable to that in Argentina in the 1990s. In the same vein, Portugal – among other countries – had to devalue its exchange rate during the recent turmoil in the EMS because the (implicitly) fixed exchange rate against the DM induced reserve outflows. The reason was the strong demand for DM due to German unification effects and the following speculative waves. But even without this additional shocks, the EMS showed an increasing divergence in real exchange rates between the North and the South because of a rather slow convergence of price levels. It could be assumed that this divergence in competitiveness would have led to some realignment anyway [Danthine et al., 1991, p. 44-46]. Moreover, if compared to the US, asymmetric shocks in Europe are arguably larger and likely to grow rather than to shrink with deeper and wider European integration in goods and factor markets [de la Dehesa, Krugman, 1992, p. 48].

Chile's and Portugal's experience show that low income countries are well advised to allow for flexible exchange rates if significant asymmetric real shock can not be ruled out. At least, they should preserve their chance to opt out from a fixed exchange rate regime in order to avoid unemployment and external imbalance. Such a chance is given in unilateral monetary integration but not in a monetary union.

3. Fiscal Integration

Fiscal integration is an issue which is only relevant for low income countries which have an option to become full members of the EU. Proponents of fiscal integration argue in favour of redistribution schemes, coordination in specific areas, and the harmonization of government activities. If valid, an advantage of regional integration over unilateral integration would be established. However, the arguments in favour of fiscal integration are not too convincing. It can be argued that fiscal cooperation rather than fiscal integration is adequate from the

low income country perspective. Fiscal coopertion, in turn, gives no advantage to regional integration and is even independent of other integration policies.

a. Redistribution, Coordination, Harmonization, or Cooperation?

Arguments in favour of regional redistribution and coordination of fiscal policies stem from problems arising because of integration in money, factor, and goods markets. With a single money in a monetary union, each country's monetary policy is no longer autonomous but depends on the monetary policy of the common Central Bank and on the balance-of-payment situation, i.e. on reserve flows. This excludes the possibility of having an individual monetary stabilization policy in line with a country's preferences or of balancing asymmetric shocks by adjusting the money supply [von Hagen, 1991, p. 14]. Therefore, one branch of the theory of optimum currency union argues (e.g. Kenen [1969] that a currency union requires an automatic redistribution scheme between participating countries in order to balance country specific shocks. If shocks are temporary, a counter-cyclical fiscal policy is possible with deficit spending. Automatic redistribution between countries is not required. If shocks are permanent, real adjustment is necessary and redistribution gives an incentive to delay adjustment due to moral hazard effects. Moreover, redistribution can even increase the impact of asymmetric shocks [Vaubel, 1988, p. 238]. Assume that redistribution is tied to income changes and that both trade and capital flows are balanced. If income decreases in one country because of a worsening of the terms of trade, import demand decrease and a trade surplus may be realized. At the same time, the redistribution induces a net capital inflow which requires a trade deficit. The need for real exchange rate adjustment increases relative to a situation without redistribution. From the low income country perspective, it remains open to question whether or not inter-country redistribution for stabilization purposes compensate for the disadvantages of one money described in the last section or if it rather aggravates adjustment problems.[29]

With an integrated factor market two problems may arise: over-borrowing and a restriction of income redistribution policies in a country. The over-borrowing argument assumes the union's financial markets to be inefficient and isolated from world capital markets and/or the union's Central Bank to accommodate fiscal deficits [Willms, 1992, p. 221ff.; van Hagen, 1991, p. 28ff.]. It argues in favour of a coordinated fiscal policy via ceilings on the countries' fiscal deficits.

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[29] Additionally, Fratianni and von Hagen [1993] argue that, for the case of the EU, fiscal centralization raise the likelihood that fiscal policy will be used as a tool for union-wide discretionary macroeconomic policy limiting the credibility of any actions taken by the European Central Bank.

But such ceilings are neither necessary nor sufficient to control fiscal spending. They are not necessary because the financial market needs not to be isolated and the union's Central Bank needs not to accommodate fiscal deficits. The first best solution is to open up financial markets and to make the Central Bank independent. Moreover, monetary unification eliminates the exchange rate risk. This strengthens the link between risk premia and the borrower's individual risk and improves the efficiency of financial markets. Additionally, if voters and investors are mobile, the penalties for imprudent public borrowing become high. Ceilings on public borrowing are also not sufficient to control borrowing because they lead to an increase of off-balance sheet operations [von Hagen, Fratianni, 1991, pp. 244ff.] making a control of the budget even more difficult. For low income countries, ceilings on public borrowing are highly inefficient because this group of countries depends on external funds to finance investment. Therefore, it would be rather important for them to *relax* credit constraints.

Without doubt, factor mobility limits the possibility to redistribute income from one factor of production to the other and within factors. But factor mobility does not necessarily imply the collapse of national redistribution schemes and the need for a centralized income redistribution scheme [Sinn, 1992, p. 192f.]. Redistribution becomes only limited to the extent justified by workers' and investors' preferences if the free rider problem could be solved. If exit and entry is free for the net taxpayer and the welfare recipients, it is indeed inevitable that the former will emigrate and that the latter will immigrate. The first best solution is not, however, to centralize redistribution or to restrict mobility, but rather to untie the link between the freedom to move to preferred locations and the freedom to leave and to join redistribution schemes without costs. If exit and entry fees have to be paid, the free-rider problem is solved and redistribution becomes an instrument of institutional competition. This has important implications for low income countries in an economic union. The preference for income redistribution can be assumed to be positively correlated with income so that low income countries have a low preference for redistribution relative to high income countries. By lowering costs for investors or high-skilled workers due to low redistribution payments, the low income country could attract investment and human capital and improve its competitive strength (see Section III.1.). In other words, a common inter-personal redistribution policy would especially hurt low income countries.[30]

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[30] This holds also if redistribution is financed by developed countries. In this case the fiscal implication could be neutral, but the allocation effect remains.

To the contrary, low income countries participating in an integration scheme with high income countries may ask for inter-country redistribution from rich countries to poor countries because they face the need to compete while the use of tax instruments is restricted. As argued above, the integration of goods and factor markets makes catching up possible if low income countries succeed to compensate disadvantages due to small market size and low endowment with human and physical capital by providing favourable conditions for investors. Such an institutional competition includes the regulatory framework and public investment. At the same time, market integration and monetary integration limits or prohibits the use of tax instruments which are more important for low income than for high income countries. However, not redistribution but capital market integration should be of first priority in such a situation because it is sufficient to provide the financial funds for investment and it avoids moral hazard effects which are connected with redistribution schemes.

Another set of arguments in favour of the harmonization of government activities stem from the optimal provision of public goods in a region rather than from the completion of integration policies. However, the degree of tax harmonization should be as low as possible to allow low income countries to find an adequate tax structure to finance productivity enhancing public investment. Under competitive pressure, this might either lead to an ex-post harmonization of taxes or to a diverse structure of national tax systems [Eichengreen, 1990, pp. 154ff.]. In each case, a low level of ex-ante harmonization of taxes establishes a permanent pressure for reforming inadequate tax structures and, at the same time, maintains the possibility to attract productive activities by providing an attractive institutional environment.

The theory of fiscal federalism provides a guideline for deciding on a minimum of harmonization of government activity. The theory of fiscal federalism [Buchanan, 1950; Oates, 1972; Olson, 1969] focuses on the optimal provision of public goods by an optimal allocation of fiscal responsibilities between a central government and regional jurisdictions. Applied to the regional integration problem, the countries participating in integration constitute the regional jurisdictions, and the ex-ante harmonization of the activities of national governments constitutes the central government.

The theory of fiscal federalism establishes two principles: subsidiarity and fiscal equivalence. Subsidiarity means that the regional jurisdictions should decide on the supply of a regional public goods because they can adjust supply to regional demand. If preferences for public goods, and, hence, demand differs between regions, harmonizing supply would be inefficient and the population in regions

with a lower preference becomes a "forced rider" [Stehn, 1993, p. 35]. Fiscal equivalence means that the geographical incidence of financing the public good should coincide with the jurisdiction supplying and consuming the public good in order to exclude "free riders" [von Hagen, 1991, p. 4]. Spill-over effects and economies of scale in the production of a public good constitute a case for a general harmonization only if preferences and spillovers are homogenous for all regions and all public goods. In the more general case of heterogeneous preferences and spill-overs, the optimal solution is functional federalism [Straubhaar, 1993], i.e. different cooperation schemes between countries for different public goods.

b. Relevance for Low Income Countries

The present strategy of European integration is not favourable from the low income country perspective. To the contrary, the interventionist provision of the Maastricht Treaty, the harmonization approach to the completion of the single market, and the general strengthening of the common redistributive policies significantly impair the chances of actual and especially of would-be low income members in Central and Eastern Europe [Schmieding, 1992]. More specifically, the treaty endows the EU with interventionist competencies with respect to social, industrial, and technology policy as well as in such areas as consumer protection, the environment, health and education. Therefore, the general idea is to provide a level playing field, rather than to stimulate institutional competition.

Apart from the disadvantages for low income countries most of these policies lag either an economic rational at all or are hardly to be identified as supra-national policy areas according to the theory of fiscal federalism [Stehn, 1993]. Additionally, the subsidiary principle established in the Maastricht Treaty does not provide a safeguard against overcentralization because it is open to interpretation by EU bodies [Schmieding, 1992, p. 17f.]. Fiscal integration of this type clearly strengthens the relative advantage of unilateral integration for low income countries because this type of integration allows for an individual institutional setting and the chance to cooperate with either developed or low income countries in specific areas.

Cooperation even provides a starting point for a promotion of South-South integration [Langhammer, Hiemenz, 1990, p. 74f.]. Common interests can be found in the dealing with actual or perceived external threats or in the joint production of public goods which would be too costly for individual countries. Human resource development, food security, expansion of research especially in

agriculture, energy management, environment problems, international marketing, and improved flows of information and communication represent severe bottlenecks to economic development, particularly in the poorer countries of Africa and Central America, which could be widened by intraregional cooperation. This type of cooperation will, however, be very selective and country-specific.

IV. Summary and Conclusions

The paper has evaluated possible advantages of regional integration strategies for the low income developing and newly emerging market economies which aim at catching up with high income countries. Using unilateral integration as a yardstick, theory has shown and experience has confirmed that there is no advantage of regional integration strategies in this respect – except for second – best arguments and specific circumstances.

South-South integration, i.e. regional integration among low income countries, can be ruled out as a viable strategy at all. The basic reasons are that the internal market which is created is too small, trade diversion is maximized, and the redistribution of the zero or negative sum game becomes the major concern of participants. As a consequence, South-South integration never reached the stage of effective goods markets integration.

The systematic failure of South-South integration gives a first explanation for the increased attempts of low income countries to join a rich country club. This is to be observed on both sides of the Atlantic. In America, Mexico entered NAFTA and other Latin American countries are keen to follow. In Europe, the newly emerging market economies hoping to shorten their transition period demand for entry in the EU.

However, the attractiveness of North-South integration, i.e. regional integration between high and low income countries, stems from significant external barriers of such schemes and, generally, from the slow progress of GATT negotiations. Hence, market access by unilateral integration is constrained and the optimal choice between North-South and unilateral integration becomes an empirical question. The arguments presented in the paper clearly show that low income countries are well advised to go for the larger and more competitive market.

Even if North-South integration improves market access relative to unilateral integration, integration deepening may limit potential gains for low income countries. Especially the EU aims at integration deepening by harmonizing monetary and fiscal policy. This tendency to provide a level playing field rather

than to motivate institutional competition has been clearly shown to reduce the advantages of North-South integration for participating low income countries. The basic reason is that institutional competition is an effective instrument for these countries to compensate initial disadvantages with respect to technology and the human and physical capital stock. Therefore, low income countries are well advised not to participate in integration deepening via harmonization. This, however, constitutes a problem for the process of European integration. Integration widening and – European style – integration deepening are clearly inconsistent [see also Schmieding, 1992a].

The second best character of North-South integration suggests that the search for an optimum integration area (see e.g. Cooper [1986] and Tichy [1992]) is a misleading advice. If distortions like trade barriers and restrictions on institutional competition are removed, the optimum area for the integration of goods and factor markets is clearly the world. There are two strategies to come closer to such a desired world. The first is to change the rules of the game and to allow only for open regionalism in a GATT framework (see, e.g., Nunnenkamp [1993]) where each country irrespective of its location will have to be accepted as a member by a regional grouping if it accepts to rules of the grouping. It is to be expected that this will induce competition among regional groupings for the best institutional framework in terms of economic development. The second strategy is to follow the example of Asian and more recently Latin American countries like Chile, Argentina, and Mexico and to become important partners for high income countries in trade negotiations by becoming important trading partners first, i.e. by clearcut unilateral liberalization strategies.

Two final remarks are in order which qualify potential advantages of integration with high income countries. First, the trend towards North-South integration drives a wedge between those low income countries which enjoy the scarce good of neighbouring high income countries offering market access and those which will become more and more isolated. The latter are those who suffer most from both slow progress of GATT negotiations and the emergence of North-South trading blocs.

Second, integration with high income countries – either regional or unilateral – is not a honeymoon scenario for low income countries but implies demanding preconditions if it should initiate a process of catching up. Most importantly, low income countries have to concentrate on production according to their comparative advantages and they have to reorganize fiscal revenue and expenditure in favour of domestic rather than external taxation and in favour of investment in adequate physical, institutional, and human infrastructure.

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