# 4 The Experience of Developed vs. Developing Economies

As the vignettes of RIAs presented earlier suggest, the record of first-generation RIAs has been a mixed one. There has been gradual success – albeit with a number of hiccups and setbacks – in developed country RIAs governing the European Union, NAFTA and ANZCERTA whereas earlier RIAs in many developing country blocs failed, especially in Africa and Latin America. It is tempting to believe that the difference was because, in typical World Bank terminology, the former were outward-looking, open and efficient, while the latter were inward-looking, closed and inefficient. But those are partial answers at best and misleading at worst.[21] Things are more complex than that.

### *Why First-Generation RIAs Failed in Developing Countries*

A more satisfactory explanation for the difference in experiences of RIAs is that for RIAs to succeed, the process and sequence of successive steps towards closer regional cooperation leading eventually to regional integration, are at least as important as the direction and ultimate goal of the integration enterprise. Political will (or the lack of it) for example, is a more powerful determinant of whether an RIA is successful than the validity of rational economic argument.

But the question remains: why did first-generation RIAs succeed among developed countries but fail among developing countries? Is it because integration would yield benefits only if applied by relatively advanced trading economies of roughly equal weight, producing a wide range of tradeables, and with similar production structures? Or is it that RIAs in developing nations have failed because of the very characteristics that define *developing* economies: lack of administrative capacity, political immaturity and instability, vulnerability

21 With its wasteful, distortion-ridden and trade-diverting Common Agricultural Policy and the protection it applies to sensitive industries (i.e. those in which Japan and East Asian countries are the most competitive), the European Union (EU) is hardly an open, outward-looking, trade bloc inclined towards inclusivity. It is prone to erecting protective barriers whenever the interests of its powerful vested industrial or parastatal lobbies appear to be threatened. Even so, the EU remains more open than the developing country regional blocs of the 1960s and 1970s were – although some second generation RIAs among developing countries are arguably more open now than the EU. Nor is American trade policy, which governs the ethos of NAFTA, immune to its own forms of retaliatory bilateralism or protectionism.



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to external trade and financial shocks, etc.? If so, would this mean that developing countries should not attempt to integrate till they become more developed? The answer is that both theoretical reasons and implementation failures interacted in determining outcomes of first-round RIAs in the developing world.

The studies that have been done in exploring these issues[22] generally conclude that:

- The Vinerean[23] hypotheses which underpin the modern theory of regional integration and those of Belassa *(op. cit.)* are basically correct. Both assert that there are, at best, likely to be few benefits and potentially high costs unless RIAs are accompanied by unilateral trade liberalisation.
- The greatest benefits are likely to be obtained with RIAs among countries that have: relatively high initial (intra-regionally oriented) trade ratios; low intra-regional transport costs relative to the transport costs involved in trading with the rest of the world; higher, less dispersed levels of incomes with high elasticities of demand for imports; high propensity for investment; and greater supply-side flexibility in their production structures for responding to competition.
- First-generation RIAs among developing countries failed to raise efficiency because of: (a) relatively low import demand elasticities; (b) relatively large differences in production cost structures vis-à-vis extra-regional sources; (c) widely disparate income levels; (d) divergent rates of industrial development which made gains from intra-bloc trade uneven; (e) low levels of initial integration by way of infrastructural links or intra-regional trade; (f) similar not complementary structures of production and resource endowments; (g) inward-oriented, protectionist industrial development policies under which protection was maintained for too long; and (h) divergence and instability in macroeconomic parameters that made domestic adjustment, as well as regional adjustment, uncertain, fragile and burdensome.
- In RIAs among developing economies, the implementation of measures to lower barriers (both tariff and non-tariff) was poor whereas developed economies were more diligent. The lowering of trade barriers in almost all RIAs among developing countries was delayed or postponed largely because of the heavy dependence of the fiscus on trade taxes.
- Processes for lowering tariff and non-tariff barriers under RIAs in developing countries lacked the automatism they had in developed countries. The tendency instead was to have protracted negotiations to achieve

22 In particular those of (1) de Melo et al., (2) Robson, (3) York, (4) Oman and (5) Cable and Henderson, *op. cit.*

23 Viner, Jacob, *The Customs Union Issue*, New York: Carnegie; London: Steven and Sons, 1950.

multilateral consensus on a product by product basis. At the level of implementation, there was no strict timetable for executing trade barrier reductions.

- Such reductions were based on *positive lists* rather than across-the-board liberalisation of tariffs and non-tariff barriers with very restrictive rules of origin. Positive lists included products which were traded intra-regionally prior to the arrangements in question or were not produced in the region. They generally excluded protected products, the free trading of which might have engendered greater efficiencies despite inevitable dislocations.
- Vulnerability to bouts of exogenously induced macroeconomic instability in developing economies, or to import surges caused by economic liberalisation programmes led to immediate unilateral reimposition of trade barriers (mainly in the form of quantitative restrictions) even in those arrangements which were initially successful like the Central American Common Market.
- Where customs unions were intended, the implementation of a common external tariff was not achieved because members invariably sought exemptions from certain external tariffs (e.g. for essential imports from extra-regional sources).
- Developing country RIAs were unsuccessful, or only partially successful, in freeing intra-regional mobility of all factors – especially labour and capital.
- Satisfactory compensation schemes for losers under developing country RIAs proved difficult to design and negotiate multilaterally in a manner acceptable to all members. Problems with implementing structural adjustment programmes also led to conflicts among partners over the equitable regional distribution of costs and benefits.
- Too many developing country RIAs set up machinery to allocate resources through administrative decision-making and fiat rather than market determination for locating new import-substituting industries among different countries in an effort to ensure equity rather than efficiency.
- These mechanisms encountered administrative problems and frequent breakdowns of negotiations as a result of inter-country conflicts of interest and the impossibility of determining proper locations for particular industries in the absence of market-based criteria and incontrovertible evidence of comparative advantage – always difficult to provide in a dynamic sense.
- Intra-regional trade expansion in integration arrangements among developed countries occurred through rapid *intra*-industry trade expansion among members. Among developing countries trade expansion occurred more on *inter*-industry lines.



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- *Intra*-industry trade specialisation (i.e. trade in differentiated manufactures) and expansion was achieved without major shifts in factor proportions or entirely new technologies. Therefore it entailed relatively low transitional costs of adjustment, particularly in terms of labour dislocations.
- *Inter*-industry trade expansion was generally slower, requiring major restructuring of firms and industries. It was less susceptible to realising cost efficiencies and scale economies across a wide range of regional industries quickly, and required more adjustment assistance for compensatory purposes.
- Such costs were substantial in the short run with transitional losses reflecting long periods of labour retrenchment and re-training when firms which faced regional competition either failed or took too long to adjust and compete.
- Transitional losses were reduced to the extent that labour and capital were mobile within the region but that was not the case under most developing country RIAs.
- The political will to sustain RIAs through difficult economic circumstances was lacking in developing economies with members being prone to take soft options to ease the immediate pain at the expense of longer-term interests.
- Developing country members of RIAs were rarely able to subordinate short-term national interests to regional goals or to cede essential sovereignty to regional institutions.
- Under developing country RIAs there was a structural incompatibility between: (i) the pursuit of inward-oriented and inherently protectionist development policies at the *national* level and (ii) the ostensible objectives of *intra-regional* trade liberalisation. Powerful industrial lobbies prevented a reduction of domestic protection in key import-substituting industries.
- An unpropitious external environment facing most developing regions in the 1970s and 1980s did little to help matters. Under pressure to liberalise and adjust, many developing members of RIAs found their commitment to import-substitution strategies was inconsistent with regional liberalisation and introduced structural rigidities which were difficult to deal with through normal macroeconomic management.
- Although many RIAs among developing countries were modelled on European Union lines, most of them lacked adequate or technically competent institutional support.
- National legislation was invariably inconsistent with regional treaty commitments, but most developing countries delayed the necessary changes in their laws. Effective enforcement mechanisms and dispute settlement procedures were conspicuous by their absence.
- Developing country RIAs were aimed at the wrong objectives (inward-looking and based on high common external tariff) which did not yield

significant efficiency gains nor did they result in initial trade-diverting effects eventually being converted into trade-creating effects by capturing the potential for dynamic efficiency.

- There was more rapid intra-regional trade growth in developing regions (e.g. Asia) which had no formal regional arrangements for intra-country trade but which focused on unilateral trade liberalisation first, than there was when formal PTA/FTA/CU arrangements were entered into *before* members had undertaken unilateral trade liberalisation.

There is now a rich body of experience with RIAs in many developing regions from which various lessons might be learned in designing future arrangements. As emphasised above, most formal groupings have so far generally not fared very well, and for essentially the same reasons. Thus, their experience serves to underline the need to address the problems identified for future RIAs in developing countries, rather than to suggest possible transferable solutions from the experience of developed countries (see Annex II on Africa).

### *Lessons for the Future*

In the case of the Andean Group, experience underlines one important point: the dangers of addressing the problem of *distributional equity* by controlling foreign direct investment (FDI) inflows. The Andean Group's attempt to legislate on FDI inflows and the transfer of technology in order to promote production integration and regional balance found expression in Decision 24 in 1970. Owing to the virtual drying up of FDI inflows, the decision was relaxed in 1987, and in 1991 it was replaced by Decision 291. This assures national treatment to foreign investors and effectively signals the abandonment of the original initiative. The Andean Group went even further in establishing a common market by the end of 1993 which assured capital mobility to an unprecedented degree.

The ASEAN bloc is one of the few not to have experienced the difficulties seen in some African regional blocs. Its members have enjoyed high rates of economic growth, and its share of intra-bloc trade, at nearly 30% of total trade, is substantially higher than that of any African group. However, although this might suggest a positive example, ASEAN is not a particularly good example of an RIA *per se*. As observed earlier, until 1993 ASEAN's objectives were more political than economic. Its most notable achievements were peaceful conflict resolution and regional security among members.

An ASEAN Preferential Trading Agreement has now been established, but its practical scope has been deliberately limited. It has not resulted in any significant trade expansion among the members of the bloc that is not occurring naturally anyway. Thailand's proposal that ASEAN should establish



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an FTA has been accepted, with members agreeing to create the ASEAN Free Trade Area (AFTA) within the next 15 years.

The main lesson of ASEAN is that it is possible for fruitful transnational production links amongst the countries of a sub-region to develop, even without formal institutional support for RIAs, providing the following conditions exist: (i) a favourable economic policy climate for business enterprise – private and public, involving foreign and domestic capital – to flourish; (ii) a regional reservoir of entrepreneurial talent which is ethnically linked throughout the region; (iii) administratively capable – if not necessarily always incorrupt – domestic government; (iv) a will to encourage pragmatic regional cooperation on a step by step basis, building on small successes and eschewing grand designs; and, (v) above all, the existence of healthy and sizeable economies in which private enterprise is permitted to play the dominant economic role but with governments intervening intelligently in "governing the market".

For future RIAs among developing countries to succeed, most of the studies done have found that the following conditions would be essential:

- Strong and sustained political commitment to RIAs;
- Effective mechanisms to distribute equitably the costs/benefits of RIAs;
- Regional trade liberalisation as a complement to unilateral trade liberalisation;
- Macroeconomic stability among members with a trend toward convergence;
- Structural flexibility in converting import-substituting production structures;
- Better design of RIAs to be more comprehensive and inclusive.