

The bringing together of economic components of different national states into a wider regional economic entity is called "regional integration" (Plasschearts, 1970). Some economists have included social and political integration into this concept; others assume some forms of co-operation within the region.

Regional integration takes five major forms that representing varying degrees of integration, perceived in terms of stages. They are the preferential trading club, the free trade area, the customs union, a common market and an economic union, ranging from a loose form of market integration to a form of comprehensive policy integration.

- a) **Preferential Trading Club:** This is an agreement between two or more countries to reduce tariff and other restrictions on imports from member countries. Each member country, however, retains complete freedom to impose different tariffs and other restriction on imports for non-members.
- b) **A Free Trade Area (FTA):** Partner countries abolish tariffs and other restrictions on imports among each other, while retaining complete freedom over their commercial policies with the rest of the world. The most prominent FTA is for many years has been the European Free Trade Association (EFTA), which consists of Austria, Finland, Iceland, Luxembourg, Norway, Sweden and Switzerland.
- c) **A Customs Union:** With the provision of the free trade area, partners establish a common external tariff schedule on all imports from non-member countries. In 1968 European Economic Community (EEC) adopted a common external tariff rate applicable to non-members and established a full customs union.
- d) **A Common Market:** In addition to the provisions of the customs union, a common market allows free movement of all factors of production among the partner countries. The free movement of capital and labour represents a higher level of economic integration. The Treaties of Rome in 1957 established a common market within the European Community, which officially established on January 1, 1958, and became European Union (EU) on November 1, 1993.
- e) **Economic Union:** This includes all features of a common market but also implies the unification of economic institutions and the co-ordination of economic policies of individual members into an integrated policy though there is no real unification. Such an integrated economic policy needs to be preceded by the provision of a common market. Total integration entails the unification of major policies, including monetary, fiscal, social and other counter cyclical policies. In this case, the decision-making process of the total economic integration scheme requires an authority with supranational power. When an economic union adopts a common currency only, it is considered a monetary union.

The first three stages of integration generally constitute a form of "market integration". The customs union leads to complete market integration called the "trade and factor integration". The fourth and the

EU as a Model in International Economic Integration

Prasanna Perera *

This article presents a brief description of the theoretical foundation of economic integration with reference to EU countries. It is structured in the following manner. A brief introduction is followed by the conceptual and theoretical framework. Section 3 outlines the EU experiences. In the final section a set of conclusion is made.

fifth stages conform to a pure form of "policy integration". But, whatever the type of integration, the scope of integration generally falls within three different levels (Robson, 1998). First is national integration, whereby integration refers to a number of regions within the boundaries of one nation. Second, the regional integration refers to a group of national states member within a geographical region and third, international integration reflects the same phenomenon but on a global scale.

Conventional theories of Integration

In terms of theoretical considerations it is not uncommon to examine the theories of integration in terms of its "static effects" and "dynamic effects". The static effect of integration is dealt with what is commonly known as the conventional theory of integration. This is the pure theory that primarily concerns the mechanism of production through specialisation and of its welfare implications, specifically with respect to a customs union and to the trade in final commodities. It also considered as a "Comparative Static" analysis whereby it assumes that prices reflect opportunity costs and that trade is balanced.

Viner's viewpoint:

Jacob Viner (1950) was the exponent of the conventional theory of integration. According to Viner, when a customs union is formed, the relative prices of goods in the domestic market of the member countries are altered by the elimination of tariff barriers on imports from other members. Viner's concern was whether the effects of this alteration would be beneficial or injurious in terms of the group as well as of the rest of the world. In answering this problem, he highlighted the possible effect of economic integration. One possible effect, trade creation, occurs in a customs union under conditions where, prior to its formation, potential member countries produced behind tariff barriers, whereas afterwards one of the partners becomes a complete supplier to all members. Trade diversion, on the other hand, occurs when one of the member countries had produced the commodity inefficiently at high cost, owing to its protection behind the tariff wall, and after the customs union is able to capturing the whole market within the union. This case involves the displacement of a low cost producer outside a union in favour of a high cost producer within the union. Whatever the case, Viner contends that the formation of a customs union will raise welfare as long as the "trade creation" is greater than the "trade diversion". The net welfare result of a customs union, according to his view, depends on which effect will dominate.

Meade's proposition

Meade's approach (1956) was based on a partial equilibrium analysis and relied on the assumptions of cardinal welfare in comparing the gains and losses from trade creation and trade diversion. He introduced a number of possible cases to support his views, and explained the implications of substitution among commodities on the demand side, drawing attention away from Viner's constant cost proposition. Meade extended Viner's two goods-three country model to a three goods model. Thus this approach could provide room for complementarity in demand.

Meade argued that, in order to determine whether a customs union raises or lowers the total production cost of any given output of goods and services, one should consider not only the total volume of trade (at reduced cost following integration), but also the extent to which unit cost of the newly created trade has been reduced, as well as the extent to which unit cost has been raised due to the diversion of trade from non-member to member country. His generalisation in the formation of union is that the reduction in trade barriers would lead to some form of "trade expansion". This could be considered as an important contribution because he had included the "consumption effect" in his theory. Generally, union members will increase their total consumption of goods they import from their partners, while reducing consumption of other goods that come from the non-members. Consequently as Meade pointed out, the welfare gains from such trade expansion would reinforce the gains from trade creation and also partly offset any loss from trade diversion. Thus, in most cases, a customs union is more likely to bring economic welfare when the economies of partner countries are very competitive.

Lipsey's views

Further to the work of Meade, Lipsey postulated that real income is likely to be raised if the potential partners of the customs union conduct a significant proportion of their trade with members. He developed a similar analysis as Meade on the consumption effects, but he excluded the production effects. He employed the general equilibrium approach using the general framework of the Second Best Theory. Thus, what he viewed as a gain in the creation of the customs union could only be attained up to the "pareto-optimum" level. He demonstrated various cases where welfare could be gained in the customs union. (Lipsey, R.G. 1970). Lipsey also delineated the inter-country substitution model on both the inter-commodity and inter-country substitution model

* Senior Lecturer in Economics, Dept. of Economics, University of Peradeniya

in his general equilibrium analysis. One interesting hypothesis suggested from his model is that a customs union from competitive economies is more likely to raise real income in every country in the world than a customs union between complementary economies.

Modern theory of economic integration

The theory of customs unions examines the dynamic effects of a union and is also called the modern theory of customs union. According to the modern theory, the main benefits from the customs union can be summarised as -

- a) Industries, producing traded goods enjoy the fruits of economies of scale arising from the increase in the size of market made possible by the union allows;
- b) An increase in competition and a reduction in prices through the elimination of protection with respect to member countries,
- c) Integration will stimulate greater investment to the member countries both from intra and extra sources, improving productivity and innovation,
- d) Partner countries will have greater bargaining power in the area of trade negotiation with the rest of the world.

In addition, there are important non-economic benefits that could also be gained from regional economic integration such as non-economic protection, political stability in the region. Therefore, if one wants to analyse the theory of customs union more accurately one must consider dynamic effects.

World War II (1939-1945) had depressing effect on the European economies. Some European countries hoped that the reconstruction of Western Europe would result in an agreement to create a unified European state. The Treaty of Rome, agreed by the governments of Belgium, France, German Federal Republic, Italy, Luxembourg, and the Netherlands formally established the European Economic Community (EEC) on 25th March 1957. The ultimate objective was the formation of economic union or the full customs union.

In 1961, with the EEC's apparent economic success, Great Britain began negotiation to the entry. The EEC treaty mandated, over a 12-year period, the elimination of trade barriers among members, the development of a common effective tariff rates for non-members, and the creation of a Common Agricultural Policy (CAP). Politically, the treaty gave a greater role to national governments, though it provided the EEC to become more supranational as economic integration progressed.

One of the major obstacles in achieving full integration within the framework of EEC, was the Common Agricultural Policy (CAP). CAP encouraged the production of large surpluses of some commodities that the EEC was committed to buy. This resulted in subsidies to some countries at the expense of others. Nevertheless, supporters for fully integrated EEC argued in favour of the removal of restrictions on money transfers and exchange premiums limiting the free flow of capital, regardless of the negative effects of CAP. Consequently, a three-stage plan to achieve European Monetary System (EMS) was formulated.

The EMS was established as a first step toward achieving an economic and monetary union (EMU). Initial plans to reach complete EMU by 1980 proved overly optimistic due to currency fluctuations and the devaluation of some currencies. This resulted to have in limited economic growth and led to high inflation. The EMS was proposed to stabilise the European exchange rates and curb inflation, limiting the margin of fluctuation within the members to a small deviation. The central exchange rates were set and a common European Currency Unit (ECU) introduced. ECU was comprised of all the European currencies, weighted according to the economic importance of each country.

As Communism crumbled in Eastern Europe, many of the former Communist countries looked to the EEC for political and economic assistance. The EEC agreed to military aid and association agreements with many of these countries, but ruled out their immediate membership. An emergency summit in April 1990 made an exception in the case of East Germany, allowing it to be incorporated into the EEC upon completion of German reunification. At this same summit, West Germany and France proposed an inter-governmental conference (IGC) to pursue closer European unity in the wake of the rapid political upheaval. While, British Prime Minister Margaret Thatcher opposed calls for increased unity, John Major, who become Prime Minister in 1990, adopted a more submissive approach on the European unity. The IGC, along with a similar conference working on a timetable for the EMU, began work on a series of agreements that became the Treaty on European Union. Representatives from each EEC country negotiated the Treaty on European Union in 1991, and in December, the European Council met at Maastricht, to consider a draft. After bargaining among members, however, the final treaty was signed on February 7, 1992. A provision of the treaty mandated that the voters of each member state had to approve the European Union by referendum, the treaty was approved in October 1993. The European Union was instituted on November 1, when the treaty went into administer.

After the 1990s period the EU, European supranational organisation decided to increase and to strengthen the economic integration. Although England, Denmark, France and Germany opposed the concept of a single currency, the European Monetary Institution (EMI) approved the plan to reach a single European market by December 31, 1993. The two major goals of EMI were the creation of a European System of Central Banks (ESCB), and a European Currency Unit. The ESCB currently comprises the national central banks and the European central bank. Eleven countries accepted (Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain) EMI goals and joined the ESCBs but Denmark, Greece, England and Sweden have not accepted the idea of ESCBs. The 11-EU members and the other 4 countries however, together form the Euro System. The outcome is

common currency called EURO and the concept of "Euroland" comprising the 11 EU's adopting a common currency.

The Euro currency is being introduced in three stages. The first step, in July 1990, targeted removal of barriers in capital mobilisation, and the reduction of the regional disparities. The second step in January 1994, aimed at achieving fiscal and monetary convergence criteria and the establishment of a European Monetary Institute (EMI) before the introduction of European Central Bank. From 1st, January 1999, Euro Currency came to operate in two steps. Physical introduction of Euro currency will be on 1st, January 2002. After a six months, on 1st, July 2002, EU-11s will abolish their national currencies and use only Euro. Greece will join the group by the year 2001. The other four countries (England, Denmark, France and Germany) will not accept the Euro-currency due to number of reasons.

When the single market programme was initiated (Prior to 1985), members of the EEC received FDI inflows mainly from the United States. But the single market programme led to substantial intra-EU FDI inflows to the members. At the country level, Spain and Portugal benefited from both intra and extra capital inflows. Inflows of FDI to selected EU countries can be summarised in the following table: With increased co-operation and growth, the EU may become the major economic rival to USA, (North America and even to East and South Asia). But there are significant differences in economic development among the EU countries, including large variation in income. When the purchasing power standard is used, the incomes of Luxembourg, Denmark are twice as large as Greece and Portugal. If a country or an Economic Union has significant differences in economic development, achieving the desired fruits from the economic integration is difficult. Therefore, all countries in the particular area should have a commitment to reduce regional disparities. EU is better placed, however, to co-ordinate regional as well as other national policies, particularly in the area of having the fair distribution of income and resources in the region. In addition, EU should contribute its own resources, introduce common priorities and standards, as well as take into account regional interests when it makes policy decisions. It is worth to note that however, EU governments are not distorting trade through a subsidy wars. Thus, the regional economic integration among the EU countries is a relatively novel feature. It is improving over time. Therefore, countries with interests of forming a better economic integration framework in the South are learning from EU experience. However, in the trend towards grater integration, it should not be forgotten that in the Second Best World, while all answers are possible, they are not always possible to achieve in the age of globalisation.

References

1. Balassa, B., (1962), *Towards the theory of economic integration*
2. Central Bank, (1998), *Annual Report*
3. Dosser A., (1971), *A theory of economic integration for developing countries*
4. European Central Bank, *Monthly Bulletin, various issues*,
5. Lipsey, R.G., (1970), *The theory of customs union*
6. Meade, J., (1968), *The Pure Theory of Customs Union*
7. Plasschaerts, S. (1970), *Regional integration*, as synonymous with *Economic integration*
8. Prasanna-Perera, (1998), *Trade Creation and Diversion in ASEAN economic integration*
9. Robson, P., (1998), *The Economics of International Integration, Fourth edition*
10. United Nations, (1998), *World Investment Report*

Growth Rate of Inward FDI flows to EU, 1983 - 92

Country	%
Denmark	37
France	33
Belgium-Luxembourg	27
Ireland	27
Netherlands	22
Italy	14
United Kingdom	14
Germany	5

Source : World Investment Report, 1998, United Nation