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Ekonomia Międzynarodowa nr 8, 199-208

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2014

Artykuł został opracowany do udostępnienia w internecie przez Muzeum Historii Polski w ramach prac podejmowanych na rzecz zapewnienia otwartego, powszechnego i trwałego dostępu do polskiego dorobku naukowego i kulturalnego. Artykuł jest umieszczony w kolekcji cyfrowej [bazhum.muzhp.pl](http://bazhum.muzhp.pl), gromadzącej zawartość polskich czasopism humanistycznych i społecznych.

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# Modern trends in international economic integration development

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## Introduction

Developing world economic relations on the basis of the international division of labor is becoming increasingly significant for many national economies. The convergence and intensification of the interdependencies of states and their economic entities is the main trend of the world economy. The processes taking place in the economies of individual states and their integration groupings can not be considered without taking into account external factors conditioned by the globalization of the world economy. Increasing economic interdependencies between the economic units are clearly being manifested through the pace and duration of the world economic crises. Manifestations and consequences of the global financial-economic crises differ and mainly depend on the country and its role in the world economic system. The stability reserve of the national economy in the controversial circumstances of globalization is conditioned by the weighted combination of the governmental policy of protectionism and gaining an advantage on the international division of economic factors. A system approach is needed for the purposeful quality change of the position of the individual state in the changing architecture of the global economy.

The aims of this article are (1) to overview and summarize the theoretical background of international economic integration and (2) to define key areas and main trends in integration development in the modern world economy. First section of the article describes traditional theories of economic integration including Viner's (1950) effects of integration and Balassa's (1961) stages of economic integration and shows contributions to traditional theories by other scholars. In the second section of the article we present contemporary integration trends, describing formations such as the European Union, NAFTA, Mercosur, ASEAN, APEC and the project of the Eurasian Economic Community.

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## Theories of economic integration

All stages of the development of the world economy since the late 19<sup>th</sup> century are associated with internationalization. Its main subjects are all nation states, their unions, transnational corporations, transnational banks, international economic organizations, and world financial centers. Characteristic features of internationalization are increasing international interconnections and interdependencies of different countries, regions and business entities at various levels. An indicator of the internationalization of economic life is the share of foreign trade of a country in its gross domestic product. Globalization manifested itself at the end of the 20<sup>th</sup> century as the highest stage of the internationalization process. It was characterized by an increase in the number and variety of (1) cross-border transactions with goods and services, (2) global flows of investments, credit, human capital, and labor force, (3) scientific and technical cooperation and (4) information exchange.

There has been a significant increase in scientific and practical interest in international economic integration. In scientific terms, the international economic integration issues were well presented. Theories of economic integration can be divided into two groups – traditional ones, based on short-term static effects like trade creation and trade diversion, and new theories of economic integration, which introduced dynamic effects as criteria. The dynamic effects of integration are an expanding domestic market, increasing competitive advantages of particular industries, and redistribution of resources between the integrating parties.

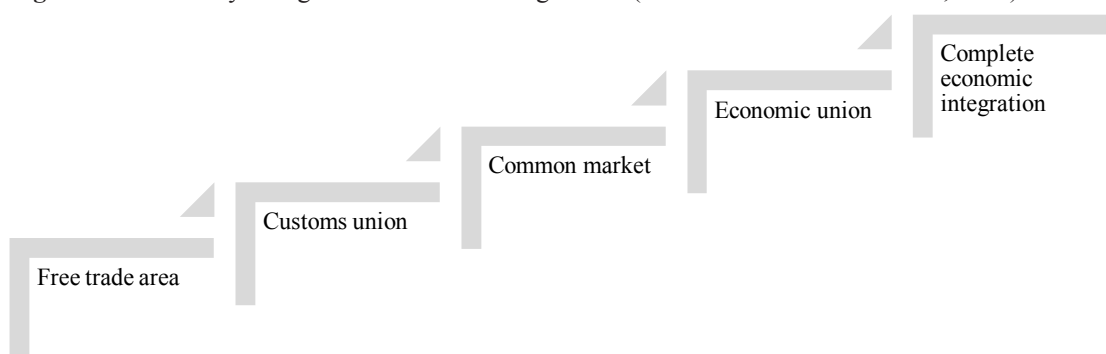
### Traditional economic integration theories

Canadian economist Jacob Viner (1950) for the first time showed not only the positive, but also the negative impact of a regional integration agreement on the example of a customs union. Because of Viner there are methodological instruments which allow two opposite integration results to be compared: trade-creating and trade-diverting effects. Trade creation refers to the case when two or more countries enter into a trade agreement, and trade shifts from a high-cost supplier member country to a low-cost supplier member country in the union. Trade diversion may occur when imports are shifted from a low-cost supplier of a non-member country of the union to a high-cost supplier member country inside the union (Hosny 2013, p.135). According to Viner, countries are more likely to integrate if integration will give them static benefits more than losses (if the trade creation mechanism will be stronger than trade diversion). Viner made ground-breaking contributions to the analysis of international trade. His work was later refined and built upon by many other scholars (Dent, Dosch, 2012, p. 6).

Significant input to the theory of international (regional) integration was provided by Bela Balassa (1961), who for the first time named five forms of integration, which are simultaneously sequential stages of increasing integration from lower to higher levels. Balassa's five stages of economic integration are: a free trade area, customs union, common market, economic union and total economic integration. A free trade area is formed by removing tariffs on trade among member nations and leaving members with autonomy in setting their tariffs on trade with non-member countries. A customs union applies a common tariff structure to trade with non-members. A common market allows

free movement of factors of production, as well as goods and services, between member states (Baldwin, Venables, 1995, p.1598). An economic union combines a common market with a customs union – the member states have a common external trade policy and free movement of goods, services and factors of production. An economic union which introduces a common currency becomes an economic and monetary union. Within a complete economic integration member states have a common economic, monetary and fiscal policy.

**Figure 1.** A hierarchy of regional economic arrangements (Own work based on Balassa, 1961)



Within his theory Balassa basically predestined the course of European economic integration. He wrote: *We propose to define economic integration as a process and as a state of affairs. Seen as a process, it includes measures to eliminate discrimination between economic units belonging to different States; considered as a state of affairs, it can be represented as a lack of various forms of discrimination between national economies* (Balassa 1961).

The two authors presented above, Viner and Balassa, founded the theory of European integration and are considered to be classics in the topic of international economic integration. However, since Balassa’s significant input, a substantial amount of research on international economic integration has resulted in theories contributing to Viner’s previous research as well as new economic integration theories based on the so-called “new regionalism” represented by dynamic effects such as increased competition, investment flows, economies of scale, technology transfer, and improved productivity.

### Contributions to Viner’s traditional theory

After Viner’s pioneering book entitled “The Customs Union Issue”, many economists reviewed and commented on it, and consequently developed Viner’s theory of economic integration static effects.

Meade (1955) argued that Viner’s trade diversion effect requires inelastic demand and elastic supply. Thus, if demand was more elastic, a customs union would increase the volume of trade even under a trade diversion effect. Meade called this effect “trade expansion” and suggested adding it to the traditional Viner analysis, because in this case trade diversion may not have such a negative impact.

Lipsey (1957, 1960) made an important contribution to the theory of customs unions. He did not agree with Viner’s conclusion that trade creation, when production

shifts from a high-cost source to a low-cost source, is considered to be positive and trade diversion is considered to be negative in terms of economic welfare. He argued that economic welfare includes both production and consumption effects, while Viner's analysis is focused on the production effect. However, the consumption effect is manifested when, after a reduction in tariff barriers, union members increase their consumption, while reducing consumption from third, non-member countries. Lipsey and Lancaster (1956) introduced differentiation among small and large tariff reductions in a customs union. They argued that while a small reduction in tariffs raises welfare, a large reduction can cause different or even the opposite result. They also concluded that the effect depends on the stage of reducing tariffs – initial stages of tariff reduction raise welfare and the final stages lower it.

Klauss (1972) introduced the terms of the trade effect notion in his study. He noticed that studies analyzing the impact of economic integration assume that they analyze the behavior of a small country with no effect on world prices. However, if the country is large enough to change world prices, it can reduce demand for imports by imposing a tariff and consequently cause a decrease in prices of these imported goods relative to its exports, and thus improve its terms of trade. Klauss argued that introducing the terms of trade effect can improve the quality of economic integration analysis.

Other important contributions to Viner's theory included discussions on the integration between competitive and complementary countries (Meade 1955, Meyer 1956), trade between countries with similar and different levels of income (Linder 1961, Sakamoto 1969), linking per capita income and the pattern of trade (Lancaster 1980, Greenway 1981). The above discussions, however, did not lead to a specific answer as to whether customs unions increase world welfare or not. As Meade summarized, the influence of a customs union depends on the specific circumstances of the case.

Static analysis used in traditional integration theories was stated to be insufficient (Hasson, 1962, p.614), therefore scholars introduced dynamic effects into economic integration analysis. This concept was first introduced by Balassa (1962) and Cooper and Massell (1965), who listed the main dynamic effects of integration as large-scale economies, technological change, the impact of integration on market structure and competition, productivity growth, risk and uncertainty and investment activity (Hosny, 2013, p.139) .

Russian scientists were also involved in the development of theoretical and methodological foundations of international economic integration (Shmeliov, 1987; Shishkov, 2001). Their research is related to the staged elimination of barriers and discrimination against non-residents, and a decrease of the economic role of state borders. For instance, Shmeliov linked the need for world integration processes with the needs of modern international division of labor, the development of scientific and technical progress, deepening international specialization and the cooperation of individual countries. Shishkov described interpenetration and linkages of national reproductive processes at the level of the economic entities and, consequently, the mutual adaptation and convergence of legal, economic, and fiscal systems arises.

International economic integration is limited to certain regions of the world, which determines the wide use of the term “regional integration”. Regional economic integration is an economic and political union of the countries due to the development of deep and stable relationships and the international division of labor. Regional econo-

mic integration can improve the competitiveness of individual countries and across groups due to the formation of regional intergovernmental economic clusters. Baldwin and Venables (1995, p. 1598) notice that 40 percent of world trade is directly affected by regional integration agreements only because Europe and North America liberalized their regional trade. This shows the importance of regional economic integration. In the second section we will present the most significant efforts of the regional economic arrangements around the world.

## Contemporary integration trends

Regional economic integration is expanding geographically and intensifying worldwide – in Europe, Asia, Africa, the Middle East, North America, the Pacific, and South America. In this section we will present current and planned regional international agreements and discuss the main trends in integration development in the modern world economy.

### The European Union

One of the most significant integration groups is the European Union, which at the beginning of 2014 included 28 nation states. The EU originated as the European Coal and Steel Community, an international organization which unified Economic countries after the Second World War. Originally, it was founded by six countries – France, Belgium, West Germany, the Netherlands, Italy and Luxembourg. In its early stages European integration was caused by the presence of common problems and complementary capabilities of national economies, with similar levels of development. In the past decade thirteen participants from Eastern Europe and the Baltic states have joined the EU. The financial crisis in the EU caused that economically stronger partners often have to target their financial resources at helping weaker economies. However, the EU consequently managed to go through all known stages and forms of economic integration. Only 18 out of the 28 states of the European Union are in the euro area and that reflects the multilevel and multispeed nature of the economic and monetary integration in the region. The future of the EU is associated with the increasing number of its member states with Macedonia, Montenegro and Iceland the most likely candidates for future membership. Increasing the number of members will increase economic diversity which may in turn increase inefficiency in decision making.

### The North American Free Trade Area (NAFTA)

Characteristic features of the formation and development of The North American Free Trade Area (NAFTA) differ from the European model of integration. Firstly, it has been uniting two highly developed countries, the United States and Canada, with Mexico for twenty years. The latter has lower economic indicators than its partners, therefore, the scope and depth of the US-Canadian integration is significantly higher than Mexican one. Secondly, NAFTA members do not aim to transform themselves into an economic union with common micro and macro economic policies. They limit their relations to

trade, investment and the liberalization of labor markets, maintaining several exceptions in the free economic relations.

Certain problems clearly manifest themselves within the North American integration. They are caused by the increasing inequality of member states, the increase in the US deficit of trade balance within the free trade zone, and the increasing immigration flow from Mexico. Positive results are observed for the integrating parties as well, however, they differ substantially. For the United States it is significant increase in turnover, the use of foreign raw materials and other resources at a lower cost, and an increase in capital export. The closer connection of Canada to the US economy empowered its growth and allowed it to pull a number of indicators to the level of more developed partners. For example, GDP per capita in Canada and the US are now quite comparable. Entering the global economy within this group of developed countries allowed Mexico to enter other markets, and to get loans and investments. However, they had to give up their import-substituting development strategy, which caused social problems and a loss of independence.

### Mercosur

Another example of international economic integration is Mercosur (esp. Mercado Común del Sur). It is a common market of the South American countries created by the economic and political agreement between Argentina, Brazil, Uruguay, Paraguay, and Venezuela. In December 2012, the protocol of accession of Bolivia to Mercosur was signed. Currently, it is pending ratification by all Mercosur member states. Venezuela became a new full member of the Southern Common Market after seven years of waiting. Member countries managed to overcome their disagreements over the political position of Venezuela, which undoubtedly strengthened their economic position due to oil resources. The cumulative size of the Mercosur economies is presented and compared to the developed European states in Table 1, which shows data on their nominal GDP at current prices.

**Table 1.** GDP of Mercosur and the most developed European countries in 2012, trillion USD (Own work based on the World bank data)

Countries	GDP
Mercosur	3.18
Germany	3.40
France	2.61
United Kingdom	2.43

Table 1 shows that the size of the Mercosur economy is smaller than that of Germany, but it surpasses the leaders of the European economy, France and the UK. One of the immediate results of economic integration is the interdependence of economic growth (Evdokimov, Gruk 2011). The current level of integration within Mercosur, for example, means that an increase in GDP growth in Brazil by 10% inevitably leads to an increase in GDP growth by 3% in Argentina. The same effect was revealed in the economies of Uruguay and Paraguay (Popovich, 2000). Currently, Mercosur regional



integration is the most successful alliance of developing countries. They conduct a policy of collective protectionism, import substitution growth and are gradually moving towards broadening and deepening their integration. The European Union is interested in cooperation with Mercosur as a trade and investment partner. They are currently negotiating a trade agreement which will cover not only trade in industrial and agricultural goods, but also services, government procurement, intellectual property, customs and trade facilitation, and technical barriers to trade.

### The Association of Southeast Asian Nations (ASEAN) and Asia-Pacific Economic Cooperation (APEC)

There have been various attempts to enhance regional integration in Asia and Africa as well. So far, the most significant efforts are the Association of Southeast Asian Nations (ASEAN) and the Asia-Pacific Economic Cooperation (APEC).

ASEAN was established in 1967 by Indonesia, Malaysia, Philippines, Singapore and Thailand. Since then, Vietnam, Laos, Myanmar and Cambodia have joined the organization. They declare that their mutual aims include accelerating economic growth and social progress, promoting regional peace and stability, and promoting active collaboration and mutual assistance. Member countries of ASEAN differ significantly in levels of economic development. While one of the members, Singapore, is a world leader in a number of high-tech industries and has one of the most advanced financial markets in the world, another one, Vietnam, is still in the early stages of developing and opening its financial markets (Bayomi et al., 1999, p.6). Such drastic differences might cause complications in the economic and financial integration of this organization.

While the European, North- and South-American integration processes are characterized by treaties and legally binding commitments, the Asia-Pacific countries applied *a non-legalistic approach to inter-governmental co-operation based on soft institutions, open regionalism, co-operative security, non-binding decision-making, convention and consensus-building*. (Dent, Dosch, 2012, p. 5) An example of open regionalism is the Asia-Pacific Economic Cooperation (APEC). APEC today includes 21 member states situated along the coastline of the Pacific Ocean, including some of the most developed economies (the US, Japan, Canada) as well as agrarian developing industries (Vietnam). APEC is remarkable due to the participation of Russia, China, and the newly industrialized countries of Southeast Asia. Such a formation of member states with overlapping interests is characterized by its complexity and contradictory character. However, this line of integration is promising due to the financial, economic and technological dynamic development of the region. Cooperation within APEC helps to curb the growth of protectionist barriers, improve the investment climate, and use the resource potential in a more efficient way. The open regionalism example of APEC is more consistent with WTO rules and norms, because it prevents the collapse of the multilateral system.

### The Eurasian Economic Union - perspectives

The geopolitical position of Russia, with its national and international economy development trends, caused the formation of its Customs Union with Belarus and Kaza-



khstan in 2010, with the intention of creating the Eurasian Economic Union in 2015. Formation of the Eurasian Union is based on the deep industrial and trade relations and use of resources for obtaining a synergy effect of the complementary economies. The primary line of cooperation will be focused on oil and gas, the energy sector and the transport industry, due to the political support and depth and intensity of current cooperation. The convergence of the post-Soviet states was determined by the stability of the Russian economy, the attractiveness of its model, and the strong position of ruble as a regional unit of account (Kirillov 2013). However, current economic instability in Russia may have a negative effect on its international relations. The ruble has lost almost quarter of its value in the last three months (as of November 2014) and the Russian government has raised interest rates to 9.5 percent. That may have a negative impact on entrepreneurship dynamics in the country, as financing will get more expensive. On the other hand, export activity is getting more profitable with the increase in interest rates. There are still some problems concerning the Eurasian Union initiative, however. Russia will have to invest additional financial resources into this integration, which is due to more political motives than any socio-economic benefits. The states which are interested in membership in the organization – Kyrgystan, Tajikistan, Abkhazia and Armenia – are poor, closely connected with Moscow and dependent on Russia. Therefore, their participation in the Common Economic Space will not increase its potential (Bartnicki, 2012, p. 245).

Analyzing the regional integration agreements described above, we can summarize that there are two main areas in contemporary integration trends:

1. Geographically close countries with a similar level of economic development unite due to intensive trade and the economic relations between them. The effect of trade creation in such unions exceeds the effect of diversion, and some dynamic changes are accompanied by economies of scale and increasing the competitive advantage of key sectors of the economy. It facilitates integration movement in the political sphere.
2. Regional unions are created because political forces do not always take into account geographical or historical features of the integrating parties, their balance of interests or levels of economic development. In such cases, markets unite, trade flows increase, but some structural differences in the economies of the united countries are retained. As a result, transnational corporations and the “integrator” states get the biggest benefits from such integration.

## Conclusion

International economic integration is considered to be a defense against the negative impact of globalization. There are two main areas in contemporary integration trends: (1) geographically close countries with a similar level of economic development form unions due to the intensive trade and economic relations between them, (2) regional unions are created by geographical and historical features of the integrating parties, their interests and the levels of economic development.

Among the most significant integration groups are: the European Union, The North American Free Trade Area (NAFTA), the common market of the South American co-

untries in Mercosur, the Association of Southeast Asian Nations (ASEAN), the Asia-Pacific Economic Cooperation (APEC) and the Customs Union of Russia, which intends to transform itself into the Eurasian Economic Union in the future.

International economic integration development trends vary significantly, which can be explained by the multipolarity of the world economy. These trends are caused by trying to resist globalization challenges and achieve collective goals through closer regional cooperation.

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## Summary

The process of the convergence and intensification of interdependencies of individual states is the main trend of the world economy. There has been an increase in scientific and practical interest in international economic integration lately.

The authors overview and summarize the theoretical background, main trends and key areas in the field of international economic integration. The most significant regional international agreements are defined.

## Streszczenie

Współczesne tendencje rozwoju międzynarodowej integracji gospodarczej

Proces zbliżania się i intensyfikacji powiązań osobnych państw jest obecnie głównym trendem światowej gospodarki. Zwiększa się zainteresowanie naukowe i praktyczne tematem międzynarodowej integracji gospodarczej.

Artykuł podsumowuje podstawę teoretyczną, główne trendy oraz obszary kluczowe w zagadnieniu międzynarodowej integracji gospodarczej. Opisujemy najbardziej znaczące obecnie na świecie przykłady integracji gospodarczej.

**Słowa kluczowe:** integracja, globalizacja, internacjonalizacja, liberalizacja, protekcjonizm

**Key words:** integration, regionalism, globalization, protectionism

**JEL:** F13, F15