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TRADE THEORY, REGIONAL INTEGRATION, AND NATIONAL ECONOMIC DEVELOPMENT: THE CASE OF SOUTHEAST ASIA

by

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Trade Theory, Regional Integration and National Economic Development: The Case of Southeast Asia

by

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1.0 Introduction

Numerous schemes for regional economic cooperation have been [illegible] among the less-developed countries. In Southeast Asia alone, efforts in this direction include the Mekong River Project, the Colombo Plan, the Association of Southeast Asia, the Asian and Pacific Council, and most recently, the Asian Development Bank.

Traditional integration theory emphasizes the net gains arising from increased intra-regional trade and greater factor mobility--gains from larger markets, from more specialization, from the attendant elimination of factor supply constraints, from economies of scale, and from increased competition [1]: The contribution of trade theory in assessing the effects of integration has been mainly focused on the comparision of gains from trade creation and losses from trade diversion [12, 13, 17, 22].

More recently, some economists have begun to doubt the appropriateness of this traditional analytical framework for studying the effects of integration in an LDC setting. With regard to trade theory, empirical studies have pointed to the conclusion that the allocative effects of a movement toward free trade may indeed be of an insignificant magnitude [14]. Criticisms of a more general nature have cited the inadequacy

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of traditional integration theory to comprehend (1) the role of industrial growth as a competing good with income maximization in the social welfare functions of LDCs [3], and (2) the importance of foreign exchange as a constraint on economic growth in LDCs [10, 15]. A common conclusion of these 'revisionist' writers is that any assessment of an integration scheme for LDCs must look considerably beyond the gains and losses from trade creation and trade diversion [3, pp. 461-462; 10, p. 42; 15, pp. 39-41].

One aspect of traditional integration theory, which has not yet captured the attention of 'revisionists', is its emphasis on regional economic gains, with a frequent neglect of important questions relating to the national distribution of such gains. However, in the case of the LDCs in general, and of Southeast Asia in particular, any realistic appraisal of the prospects for cooperation must consider the distribution problem explicitly. The presence of extreme nationalism, of accentuated ethnic, cultural, and political conflicts, and of resistance to 'exploitation' suggests the importance of national aspirations.

One such aspiration is the desire to achieve rapid industrialization. It is argued that economic development involves more than an increase in per capita GNP; the economy must be transformed from one which is predominantly subsistence-agricultural to one which possesses a viable industrial base. Indeed, it is frequently held that "...There is no other way of achieving high rates of growth (let us say over 6% annually) for the developing ECAFE countries than through a policy of industrialization serving the needs of agriculture and supported by fast agricultural growth--a sort of balanced growth with emphasis on industrialization."[1]

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[1] "Development Planning in ECAFE Countries in the Recent Past--Achievement, Problems and Policy Issues" [21], p. 7 italics ours.

A necessary condition for rapid industrialization is frequently asserted to be the achievement and maintenance of a relatively high endowment of capital per unit of labor input.[2] While such a view may not be generally valid, it is a premise held with some conviction by policy makers in the LDCs [20]. Furthermore, it can be defended by reference to several prevailing theories of economic development. Consider, for example, the Chenery and Strout factor-supply constraint model [2] in which growth at any moment is constrained by the availability of a single factor, of which foreign exchange is a principal example. The reason for the foreign exchange constraint is as follows: The industrial sector requires heavy capital goods, and until a relatively high capital-labor ratio is attained in the industrial sector, permitting the production of these heavy capital goods, they must be imported from developed countries. Thus, because the supply of foreign exchange is limited, a low capital-labor ratio has the effect of binding the rate of industrial growth. An integration plan that produces a conspicuous divergence in the growth rates of aggregate capital-labor ratios among some of its members may therefore prove unacceptable.

In this paper we shall discuss, within the framework of both classical and neoclassical trade theory,[3] the possible impact of an integration scheme on the capital-labor ratios of two member countries. Thus, while our motives shall be fundamentally 'revisionist', we shall rely on traditional trade theory models for our methodology. Throughout our analysis we shall focus solely on the relationship between the two member

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[2]While the analysis below is formulated in terms of physical capital, human capital formation could be incorporated into the model. Since our concern is not with the allocation of savings among alternative forms of investment, we shall retain throughout the assumption of traditional classical trade theory that capital is a homogeneous factor.

[3]In this paper we use the term "classical trade theory" to mean that body of trade theory which emphasizes the role of product and factor prices, and "neoclassical trade theory" to mean that which emphasizes the role of income changes.

countries, thereby excluding any consideration of the impact of relations with 'the rest of the world'. The decision to neglect third-party effects is made in the interest of simplicity and with full knowledge of the fact that such effects may be of substantial importance.[4]

It will be argued that the possibility of conflict between national economic aspirations and the results of regional integration decrease as the prospective members of a union advance to higher levels of development. This thesis is based on two propositions defended below. First, the phase of economic development in which a policy of free trade alone appears viable occurs prior to a stage of development in which integration involving both free trade and free factor mobility can take place. This statement is based on the premise that, during early phases of development, there is strong reason to believe that free factor movements would result in "perverse" flows. Second, the likelihood of success of regional cooperation greatly increases in the presence of "normal" factor movements. The reason is that factor movements, according to the classical theory of integration, tend to counter the tendency of free trade to widen the pre-integration divergence of aggregate capital-labor ratios. Thus, not only may the form of regional cooperation become more encompassing as economic development takes place, but also the probability of success markedly increases.

Section 2.0 provides the theoretical analysis upon which these generalizations are based, and highlights the relationship between regional

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[4]Within our analytical framework, for example, effective tariff rates erected differentially against the capital-intensive and labor-intensive imports from the rest of the world may significantly affect the relative rates of return to capital and labor, and hence may exert some control on the supplies of these factors.

integration and the national goal of industrialization. It is argued that a sequential relationship exists between selected elements of internal economic development and various forms of regional integration, and that the policy implications following from this relationship may increase the chances for successful integration. Assuming some form of regional cooperation is desirable, Section 3.0 examines the policy recommendations that are consistent with the analysis--policy formulated at the national, regional, and international levels.

2.0 Theoretical Analysis

Economic integration can assume many forms. We shall consider the effects of (1) a movement toward free trade and (2) a movement toward both free trade and factor mobility on national goals of industrial expansion. Within this context, we shall also examine the theoretical role of less encompassing forms of regional cooperation such as the Regional Development Bank.

2.1 Regional Integration and the Classical Trading World Model

The classical "trading world" model with variable factor supplies is initially posited.[5] This analytic framework is couched in a comparative

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[5] See Murray C. Kemp, [8], Chapter 4. The model typically considers two countries, two goods (say cloth and food), two factors (homogeneous labor and capital), and first degree homogeneous production functions which are identical between countries. Additionally, diminishing marginal productivity for each factor is assumed. Relative factor endowments--or the countries' aggregate capital-labor ratios, $(K/L)_p$ and $(K/L)_r$--are assumed to be similar enough to permit incomplete specialization, even after integration, and to insure that cloth production is labor-intensive over the range of relative factor returns consistent with incomplete specialization. These assumptions are all necessary conditions, and are moreover sufficient, in the two country, two good case, for complete factor-price equalization to occur through free trade. See H.G. Johnson [6, pp. 17-30]; P.A. Samuelson [18, pp. 181-197]; and Murray Kemp [8, pp. 45-49].

static setting and is thus designed to predict the differential equilibrium conditions resulting from the opening of trade, and the emergence of free factor movements, or both.

2.11 The Effects of Free Trade

Differential rates of industrial growth deriving from economic integration arise in part from the relationship between trade expansion and the process of internal capital formation. If, as classical economic theory would suggest, a relaxation of trade barriers between countries produces a tendency toward factor-price equalization,[6] there will be a fall in the rate of return to capital in those countries where capital is scarce relative to labor. Assuming that industrial expansion relevant to national goals relates to those goods produced by "modern" forms of technology and employing a relatively high endowment of capital per unit of labor, and assuming that the supply of capital is related to its rate of return, free trade may have a retarding effect on the industrial growth experienced by relatively "capital-poor" nations.

2.12 The Effects of Factor Mobility

If integration also implies a stimulus to factor mobility, the tendency toward equalization of factor prices may be even stronger. Nevertheless, under normal circumstances in which the capital-poor countries

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[6]See Bela Balassa [1, p. 83] and Charles Kindleberger [9, p. 100]. One would expect this tendency to be present when countries specialize in the production of those commodities which use most intensively the factors they have in relative abundance. Of course, sufficiently different production or demand conditions, as well as the presence of "factor-reversal", can give rise to quite different specialization patterns.

would be the recipients of capital and suppliers of labor, the inter-country flow of factors would serve to attentuate the undesirable effects of free trade on industrial production.[7] Thus, when factor price equalization occurs through free trade alone, there is a tendency for the capital-labor ratios of the capital-poor countries to contract. By contrast, the basis for factor-price equalization through factor mobility is the disappearance of inter-country factor proportion differences. When both factors are present, it is not clear what the overall effect of factor-price equalization will be on the relative capital-labor endowments.

The effect of free trade and factor mobility on relative capital-labor ratios is no longer indeterminate, however, if as is likely in Southeast Asia, factor movements are contrary to the behavior dictated by traditional trade theory. On the onehand, due to a variety of causes including extreme nationalism, low levels of education, and high costs of movement relative to wage differentials, labor migration may be an insignificant component of any cooperation scheme in Southeast Asia. On the other hand, for two separate reasons, capital may well move in the theoretically adverse direction of the relatively capital-rich members.

First, capital may flow to those countries which already enjoy a concentration of capital and technology in order to take advantage of what has been called "economies of agglomeration" [1, 19]. Within the classical model, the necessary modification would entail relaxing the assumption of identical production functions between countries.[8]

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[7] See Robert A. Mundell [16].

[8] Consider, for example, Cobb-Douglas production functions in which the "technological shift coefficients" in the capital-rich country are

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Second, capital may flow adversely if differences occur between real rates of return as derived from production functions and those actually received by owners of capital. For expositional convenience, this differential may be regarded as having resulted from a tax on capital income. It must be emphasized that a 'tax' is employed here both for direct taxation and as a proxy for a host of other conditions common to the Southeast Asian setting. All these conditions can be analyzed within a 'taxation' framework, which accounts for any and all differences between the net rate of return (after taxes) to capital and the <u>production-determined</u> real rate. For example, the threat of confiscation to either capital or to capital income will have the same effect as a tax, assuming that suppliers of capital discount their actual receipts by an appropriate risk factor. Alternatively, the costs of hedging for exchange rate variations may also account for these differences.[9]

Recall that in classical trade theory both factors are paid the value

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(8, continued)greater than those in the capital-poor country. (The "shift coefficient" is the A in $Q = AL\ K^{1-}$). Not only will factor movements be perverse, but trade will not even partially offset this adverse effect. Since it is the ratio w/r (the ratio of factor payments) which determines relative costs, and since the shift coefficients cancel in the ratio (assuming factors are paid their marginal products) the capital-poor country will typically specialize in labor-intensive production, thereby aggravating the adverse effects of capital migration. The overall effect of integration on $(K/L)_p$ is therefore unequivocally harmful. (In cases where elasticities of substitution differ--which cannot be the case in the present example--factor reversal may be present and, if so, constitute an exception to the foregoing conclusion.)

Perverse capital movements are also possible whenever demand conditions are sufficiently different between the trading countries to reverse the usual relationship between relative real rates of return to capital and relative capital scarcity. For a graphical presentation of the conditions giving rise to perverse capital movements, consult Knowles [11].

[9]An example of the present disparity in tax structures in found in the capital income tax of Hong Kong, 12 1/2% and that of Malaya-Singapore, 40% [5, p. 7]. Or alternatively, compare the incidence of exchange rate variability (actual or potential) and domestic inflation with the incidence of relative paucity or abundance of capital.

of their marginal products. Now if a tax on capital is introduced into the model, and if the tax varies between countries, it is quite plausible that while the inter-country ranking of real rates of return is 'normal' (that is, the capital-poor country enjoys a greater real return to capital), the ranking of net rates may be reversed (the capital-rich country's net rate is higher). In economic terms this may occur either when there is a relatively heavier tax or when the tax incidence (net distribution of taxation returns) is more unfavorable to the owners of capital (the rich) in the capital-poor countries.

In this case integration limited to free trade will produce results similar to those already examined: As long as one of the goods is capital intensive in both countries, integration will be harmful to the relative capital endowment of the capital-poor country. If integration additionally includes factor mobility, the situation will be further aggravated since capital will move perversely in the direction of the higher net rate of return. Regional equilibrium may not, in this latter case, be attainable before the capital-poor country is drained of its total capital stock. Trade and factor equilibria will tend to be incompatible. Since the two real rates of return and the two net rates cannot be equal simultaneously, a regional equilibrium is possible only if the divergence between the aggregate capital-labor ratios in each country becomes great enough to cause factor reversal.[10] However, with or without equilibrium, the situation is unequivocally harmful to the relative capital endowment of the pre-integration capital-poor country.[11]

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[10] Factor-reversal cannot, of course, occur if all production functions have the same elasticities of substitution: Such is the case, for example, when the production functions are of the Cobb-Douglas variety.

[11] (continued on the next page)

2.13 Summary and Conclusion

The analysis of the classical free trade model yields the conclusion that if integration is limited solely to free trade, the relative capital endowment of the capital-poor country (C_p) will decline. If, additionally, free factor mobility takes place, the mildly optimistic conclusion results that integration may not necessarily be harmful to C_p.[12] This conclusion may plausibly be reversed, however, if the model is modified to include realistic assumptions regarding differential rates of taxation between countries, possibilities of capital confiscation, variations in exchange rates, or the existence of different production functions.[13]

In most cases it is impossible to specify from the model the direction of the effect of integration on the relative capital endowment of C_p without

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[11] If the assumption is relaxed that one of the goods be uniformly capital-intensive, trade may result such that both countries will specialize in either labor-intensive or capital-intensive production. Equilibrium will be possible since the requirement that factor prices be equal applies only when one of the goods is uniformly capital-intensive. If both countries specialize in capital-intensive production trade will serve to offset, at least partially, the effects of perverse capital flows. If specialization is labor-intensive, however, the effects of trade will aggravate those of perverse capital movements. The overall effect of integration will, in this latter case, be harmful to the relative capital endowment of C_p.

[12] It can be shown that in the one special case where factor reversal takes place such that specialization is capital intensive in both countries, integration will unequivocally expand the capital endowment of C_p. The conditions for factor-price equalization in this case are examined by Kemp [8, pp. 135-36].

[13] Recall that perverse capital movements are also possible whenever demand conditions reverse the usual relationship between relative rates of return to capital and relative capital scarcity.

completely specifying the nature of the production functions as well as their individual paramater values. We have, however, delineated a number of cases which are both adverse and plausible. Furthermore, since the sources giving rise to these 'adverse' situations presumably diminish as the level of development advances in both countries, the potential success of the economic union also increases. Before expanding on the policy implications of these theoretical developments, let us consider briefly whether the conclusions of our analysis, as conducted thus far, are affected by further consideration within a neoclassical, as distinct from a classical, framework.

2.21 Regional Integration and the Neoclassical Tradition

Since trade, according to Neoclassical tradition, encourages more specialization, one must also consider, as an aspect of integration, the impact of any resulting increase in income and productivity. Specifically, increased real income in each of the countries should raise the level of saving. Thus, in contrast to the results of the classical analysis, an increase in income may offset the tendency for saving to decrease because of a drop in the marginal productivity of capital. Under certain circumstances, accumulation may even increase.

Since our analysis is concerned only with the relative rates of capital accumulation, a Neoclassical reversal of our previous conclusions is seemingly possible only in the case where the distribution of income gains through integration is sufficiently in favor of the relatively labor-intensive, and hence typically primary goods, producer. While we hesitate to analyze and synthesize the plethora of literature relating to terms of trade between realtively "industrial" and "primary goods producing" countries, we can hold that, at the least, the terms of trade

will be unlikely to move in favor of the primary producer. If we accept the neutrality of income effects or, as the weight of much of the literature would appear to support, a relative distribution of trade gains toward the non-primary producer, then the conclusions of the classical model concerning the impact of trade and factor movements are either unchanged or are reinforced by the analysis of the neoclassical framework.

3.0 Policy Recommendations

While prospective countries to an economic union recognize well established regional economic gains, we have argued that a minimum constraint to acceptance of economic cooperation is that, as a result of the integration scheme, the relative rate of industrial progress of any single member does not significantly suffer. Thus the impact of integration on the relative capital endowment of each member nation becomes an important criterion of success. This becomes increasingly true for countries with low levels of economic attainment, the LDCs, given the extreme sensitivity to and aspiration for advances in industrial progress.

3.1 Integration Limited to Free Trade and the Internal Capital Market

Integration limited to free trade would, in the absence of definite counter-measures, diminish the relative capital endowment of the capital-poor members. This follows from the tendency toward factor-price equalization together with the premise that the domestic supply of capital is positively related to its rate of return.[14] Successful regional

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[14] Whereas few economist are willing to hold that free trade results in complete factor-price equalization, most concede that a tendency will at least be present among countries exhibiting similar characteristics. Bela Balassa: "We conclude that, other things being equal, trade will reduce differences, in factor prices within a customs union, provided that the

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cooperation thus involves definite steps to offset the undesirable effects of integration on the capital-poor countries.

One approach would be to compensate for a movement along the capital supply schedule of such countries by an appropriate outward shift of the same schedule. While this shift can be accomplished by a number of techniques, possibly the most promising involves the increased and extensive development of the internal capital markets. There is persuasive evidence that the necessary savings are available.[15] The chief problem lies in attracting them into some form of savings institution.[16] In explaining the relatively high savings rates of entrepreneurs in Indonesia, for example, Kelley and Williamson note that the entrepreneur, among other factors, 1) possesses greater knowledge of capital market procedures and thus can take advantage of savings opportunities which are less available to others; and 2) may face a greater internal rate of return on assets, given market imperfections.[17]

(14, continued) conditions of production show no great dissimilarities among the participating countries." [1, p. 83]. Charles Kindleberger: "But while full factor-price equalization may be an intellectual curiosity rather than a significant proposition for the real world, the tendency toward factor-price equalization is much more meaningful." [9, p. 100].

[15] See [7] and [5].

[16] One observer emphasizes the lack of encouragement of the small saver by the large city banks: "Especially in countries with a history of colonialism, banks are not only imposing in appearances, but also retain certain traditional impressive airs... Despite repeated advertisements, many people still do not realize that banks will accept as little as one dollar to open a savings account. Even if they do, many of them shy away, considering themselves too small a saver to even pass through the massive door of the banks." [5].

[17] Allen C. Kelley and J.G. Williamson [7, p 8].

3.11 National Economic Policy

A further development of Southeast Asian internal capital markets could fruitfully proceed along several lines. First, the extension of the present commercial banking system into the rural areas could be accelerated. Without this extension, a large source of capital funds will remain virtually untapped. Second, other kinds of financial intermediaries--stock markets, savings banks, credit unions, rural financial institutions, insurance companies--might be established or extended, thus providing prospective savers with a wider array of financial assets. Under existing conditions, as Gurley and Shaw have noted, an exhaustion of the saver's demand for cash holdings leaves no alternative than to spend the remaining income on consumption.[18] Third, national governments might increasingly engage in information campaigns to stress the value of frugality and savings, to break down traditional distrust and aversion to banking institutions, and to educate bankers concerning the value and role of small savers.

3.12 Regional Economic Policy

As an integral aspect of a regional cooperation scheme, a development bank might allocate a disproportionate share of its investment funds to the relatively capital-poor members. Additionally, preference might be shown to those investment projects which encourage directly or indirectly the development of internal capital markets and the use of internal savings.

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[18] John G. Gurley and E.S. Shaw [4].

A regional development bank is most useful where integration is limited to free trade. In this case the bank's investment compensates, at least partially, for the effect of factor-price equalization and thus acts as a substitute for normal capital movements. This concept of the role of regional development banks is familiar to both the theory and the practice of intergration. By the end of 1963 the European Investment Bank had, for example, allocated 66% of its total investment to Italy, clearly a relatively capital-poor member of the Common Market.[19]

3.13 International Economic Policy--Foreign Aid

To the extent that the promotion of regional economic cooperation in the LDCs is considered a desidaratum of international influence, at least two major areas of policy are consistent with the above goals. The first lies in supporting the development bank and in promoting the allocation policy of favoring the capital-poor countries. The second lies in stimulating the development of internal capital markets through foreign aid. Coupled with a relative shift of total resources to the capital-poor countries, technical assistance and initial capital could be provided to broaden and deepen the existing range of financial institutions.

Aid so directed would possess certain advantages over that allocated to alternative, more traditional forms of investment. First, the aid would not displace any appreciable amount of private investment; it can be expected instead to stimulate additional domestic investment by making more capital funds available through institutional channels. Second, the aid to financial institutions would not necessarily involve

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[19] H.O. Schmitt [19, p 10].

additional public ownership or control of production. Third, additional foreign investment from private sources may be encouraged. Fourth, aid concentrated on the development of internal capital markets, unlike that provided in the form of real goods or as direct investment, does not result in dependence on the part of recipient countries; indeed, they may become increasingly independent of foreign resources. And finally, aid in such form falls in the category of 'self help', a principle of foreign assistance attractive to recipient and donor nations alike.

3.2 Integration with Free Trade and Factor Mobility

Under normal circumstances, factor mobility will tend to increase the chances for successful regional cooperation. Capital movements in the normal direction of capital-poor countries will compensate at least partially for the effects of free trade. In Southeast Asia, however, capital movements may be perverse for a variety of reasons. The theoretical analysis of Section 2 demonstrates how they can arise out of differential tax incidence as well as from sufficiently different demand and production conditions. In a realistic setting, this list can be expanded to include exchange rate instability, inflation, discrimination against capital-owning minorities, political instability, the likelihood of future war, and the threat of confiscation. Most of these factors are present in Southeast Asia, and tend to produce perverse flows of capital, or perhaps more appropriately, "capital flight".[20] If integration is permitted to make such movements easier, there is no way of ascertaining the extent to which the limited capital resources of capital-poor countries would suffer.

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[20] [5, p. 1].

The policy measures consistent with the achievement of normal capital movements are both difficult to attain and, in some instances, politically unpalatable: political stability without resorting to ethnocentric nationalism, balance of payments stability in the presence of unstable export markets for primary products, a diminution of capital tax disparities between countries in a situation where the electorate is most often sympathetic to greater, instead of less income equality. The presumption is, however, that most of these measures will become more easily attainable as 1) the regional level of economic development increases; and 2) the disparity in levels of national economic attainment diminishes. Thus the primary mechanism for attenuating the adverse effects of free trade on the capital stock of the capital-poor country becomes increasingly operative as economic development takes place. This set of circumstances gives rise to the notion that a minimum level of economic development must be achieved before economic integration can be successful. Alternatively, a movement toward integration before this stage is reached calls for a conscious policy of internal capital market development, coupled with the types of policies noted above in Section 3.1.

4.0 Conclusion

The brightest prospects for economic integration in Southeast Asia rest at present with schemes limited to free trade. The difficulty with which obstacles to normal capital flows can be removed, as well as a consideration for possible harm resulting from perverse movements, makes it unlikely that any scheme can be broadened, at least in the foreseeable future, to include free capital markets.

Any workable scheme for integration must consider an increase in the

domestic supply of capital in the capital-poor countries as a substitute for normal capital movements. This increase can be obtained from three sources: the development of internal capital markets at the national level; the establishment of a development bank at the regional level; and foreign aid at the international level. Without such a substitute, it is likely that free trade, by producing a tendency toward factor-price equalization, will cause a deterioration in the relative capital endowment of the capital-poor countries, thus hindering the prospects both for industrialization and for regional integration.

While these specific conclusions apply directly to Southeast Asia, their general applicability follows from the theoretical relationship, on the one hand, between the stage of economic development and, on the other hand, the process of industrialization, the factors underlying perverse capital movements, and the relative development of internal capital markets. An understanding of these relationships not only expands considerably the analytical framework within which integration can be evaluated, but also delineates areas of policy consistent with the movement toward regional economic cooperation, particularly in the less developed countries.

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