

# Regional Economic Integration

# Types of regional trade agreements

- Preferential trade agreements
- Free trade area
- Customs union
- Common market
- Economic union

# Preferential trade agreements

A trading arrangement in which a nation grants partial trade preferences to one or more trading partners.

# Free trade area

A trading arrangement that removes all barriers to trade among participating nations but that allows each nation to retain its own restrictions on trade with countries outside the free trade area.

# Customs Union

A trading arrangement that entails eliminating barriers to trade among participating nations and common barriers to trade with other countries outside the group.

[http://en.wikipedia.org/wiki/Andean\\_Community](http://en.wikipedia.org/wiki/Andean_Community)

# Common Market

A trading arrangement under which member nations remove all barriers to trade among their group, erect common barriers to trade with other countries outside the group, and permit unhindered movements of factors of production within the group.

<http://www.eac.int/about-eac.html>

# Economic Union

A trading arrangement that:

- commits participating nations to remove all barriers to trade among their group
- to abide by common restrictions on trade with other countries outside the group
- to allow unhindered movements of factors of production within the group
- to closely coordinate all economic policies with other participants.

<http://geography.about.com/od/geographyintern/a/euoverview.htm>

Measuring how much regionalism  
matters for trade?



Country of origin	Amount exported	Exported to
Country 1	\$45	Country 2
Country 1	\$55	Country 3
Country 2	35	Country 1
Country 2	25	Country 3
Country 3	45	Country 1
Country 3	15	Country 2

# Measuring How Much Regionalism Matters for Trade

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- Trade Share
  - One nation's flow of international trade as a percentage of a regional or global trade total.
- Trade Concentration Ratio
  - The sum of bilateral trade shares within a regional trading bloc divided by the region's share of world trade.

# Trade Concentration Ratio

- A trade concentration ratio less than unity implies that the trading bloc trades less intensively within itself than it trades with the rest of the world.
- A trade concentration ratio greater than unity implies that the trading bloc trades more intensively within itself than it trades with the rest of the world

**Figure 5-1**

**World Trade Shares**

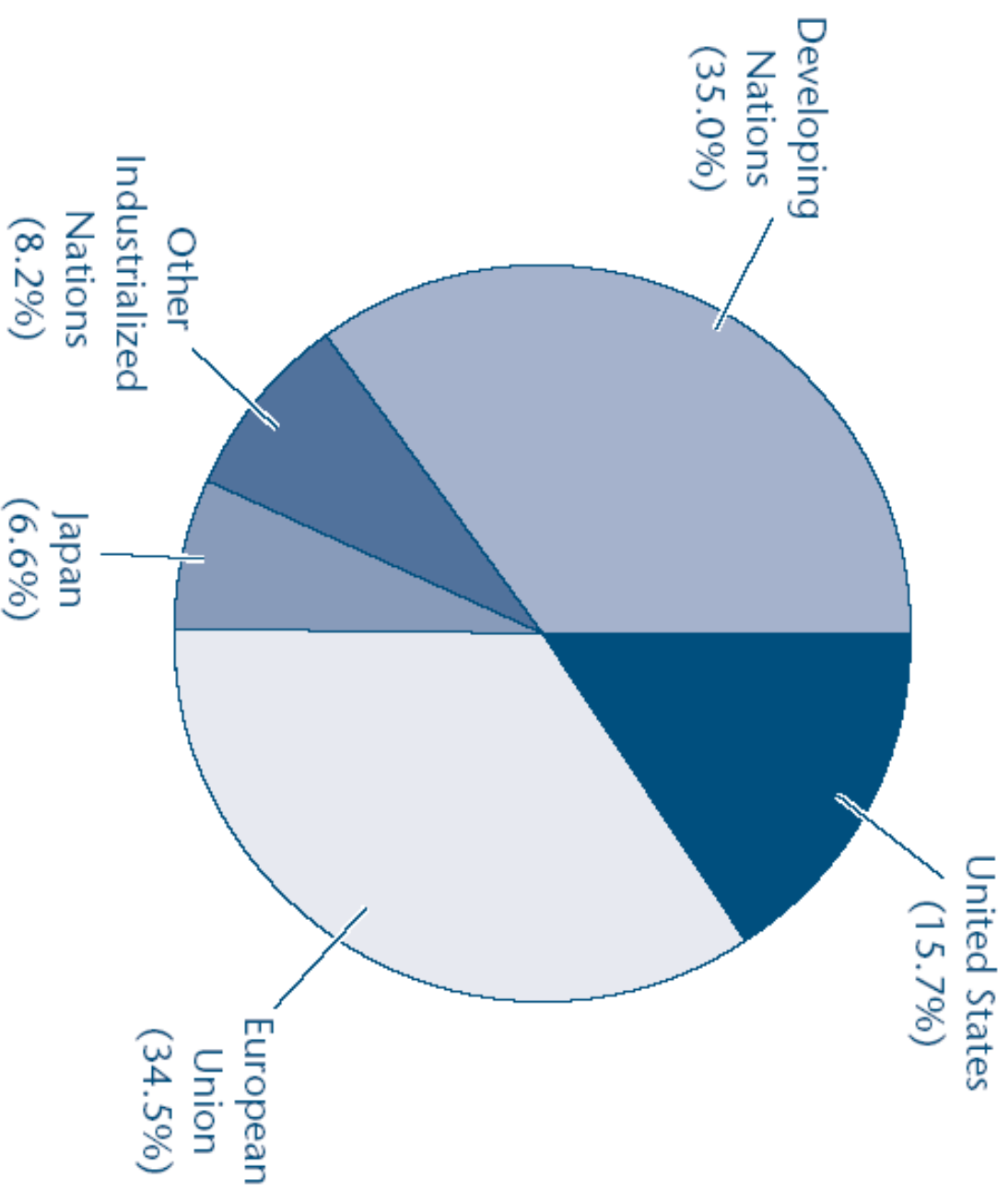


Table 5-1a

Regional and World Trade Shares of Nations in Selected Regional Trading Blocs

	Share of Trade with Regional Trading Bloc	Share of World Trade
<b>NAFTA</b>		
United States	32.2	15.48
Canada	78.5	3.96
Mexico	82.9	2.63
<b>Mercosur</b>		
Argentina	26.6	0.47
Brazil	16.0	0.75
Paraguay	58.0	0.04
Uruguay	43.7	0.02
<b>Andean Community</b>		
Bolivia	16.6	0.02
Colombia	15.4	0.19
Ecuador	13.9	0.08
Peru	11.3	0.09
Venezuela	8.4	0.27

Table 5-1b

## Regional and World Trade Shares of Nations in Selected Regional Trading Blocs (cont'd)

	Share of Trade with Regional Trading Bloc	Share of World Trade
<b>ASEAN</b>		
Brunei	40.2	0.03
Indonesia	17.2	0.74
Malaysia	29.7	1.16
Philippines	15.1	0.55
Singapore	34.2	1.74
Thailand	20.9	0.84

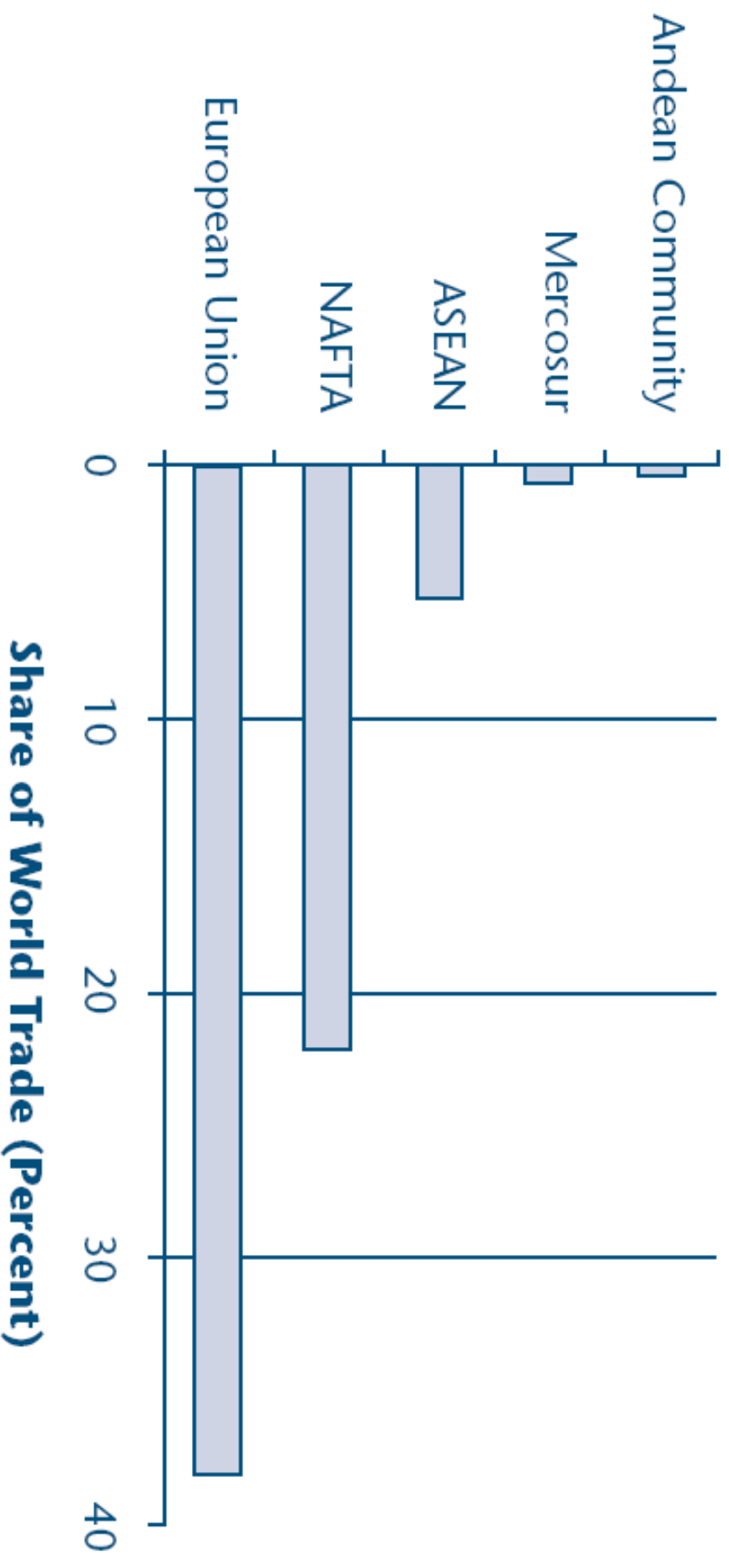
Table 5-1c

## Regional and World Trade Shares of Nations in Selected Regional Trading Blocs (cont'd)

	Share of Trade with Regional Trading Bloc	Share of World Trade
<b>European Union</b>		
Austria	65.3	1.08
Belgium	71.6	2.75
Denmark	67.8	0.74
Finland	57.2	0.71
France	63.0	5.05
Germany	54.2	8.08
Greece	54.5	0.30
Ireland	58.3	0.98
Italy	55.6	3.64
Luxembourg	83.3	0.15
Netherlands	65.3	3.43
Portugal	76.1	0.47
Spain	66.6	1.95
Sweden	59.0	1.19
United Kingdom	53.0	4.76

**Figure 5-2**

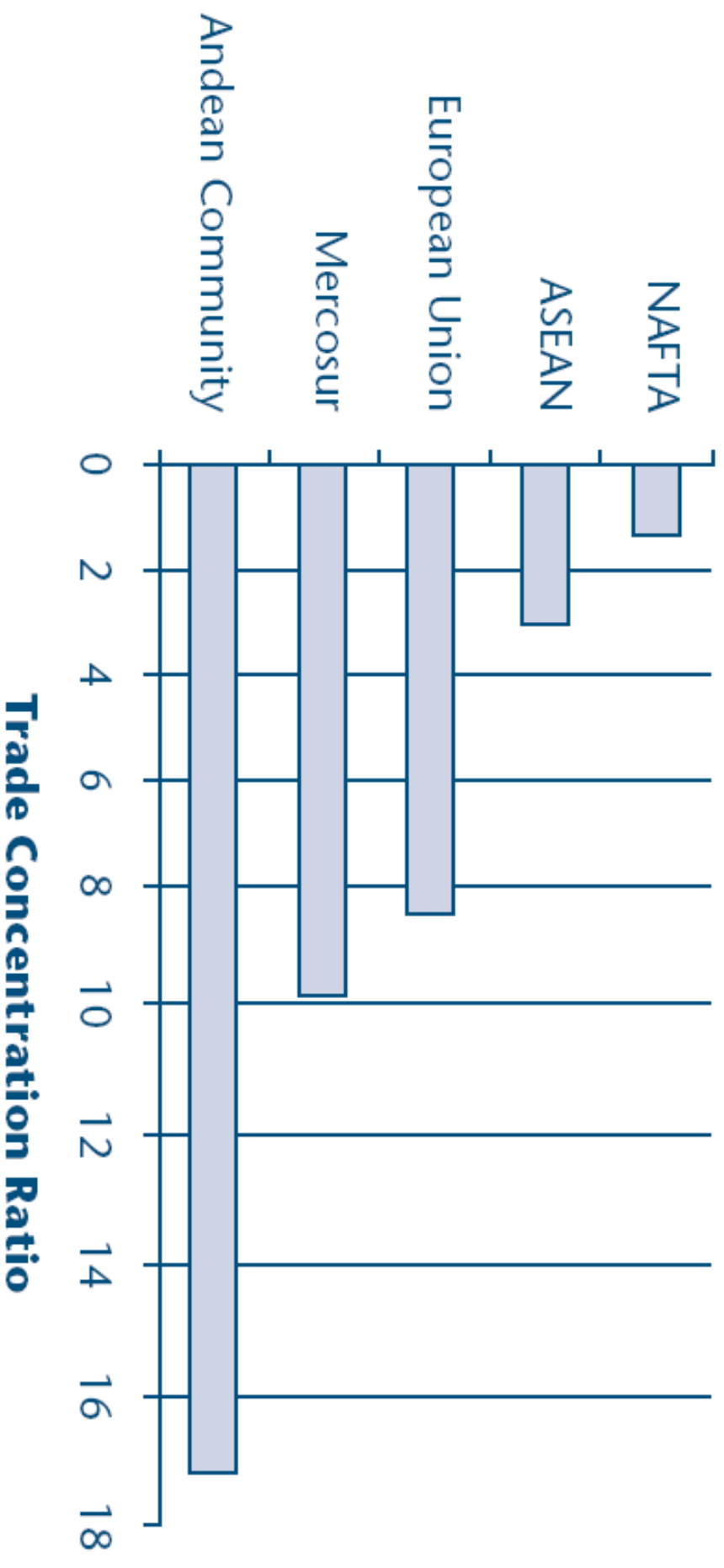
**Trade Shares of Selected Regional Trade Blocs**





**Figure 5-3**

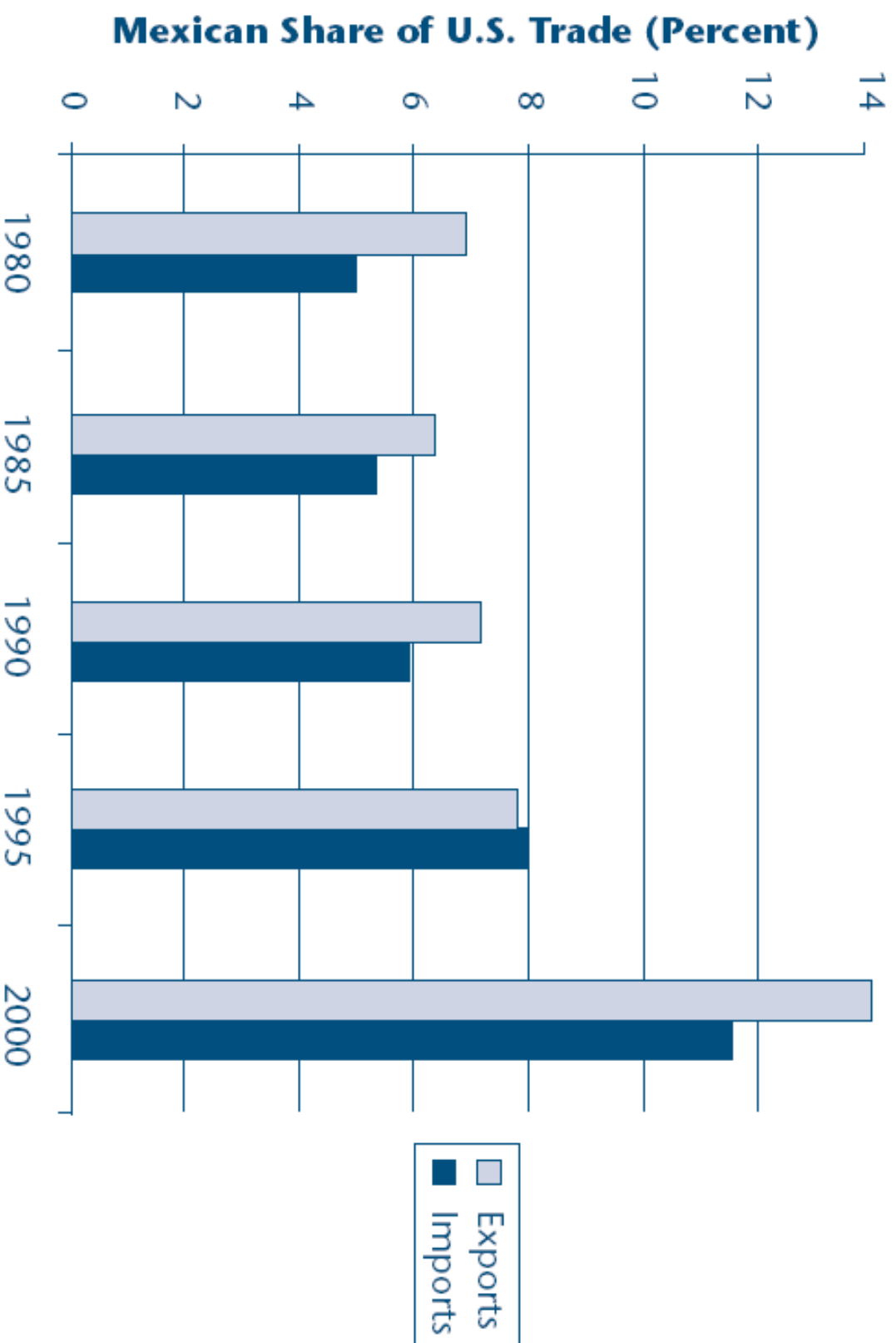
**Trade Concentration Ratios for Selected Regional Trade Blocs**



# Experience with the North American Free Trade Agreement (NAFTA)

**Figure 5-4b**

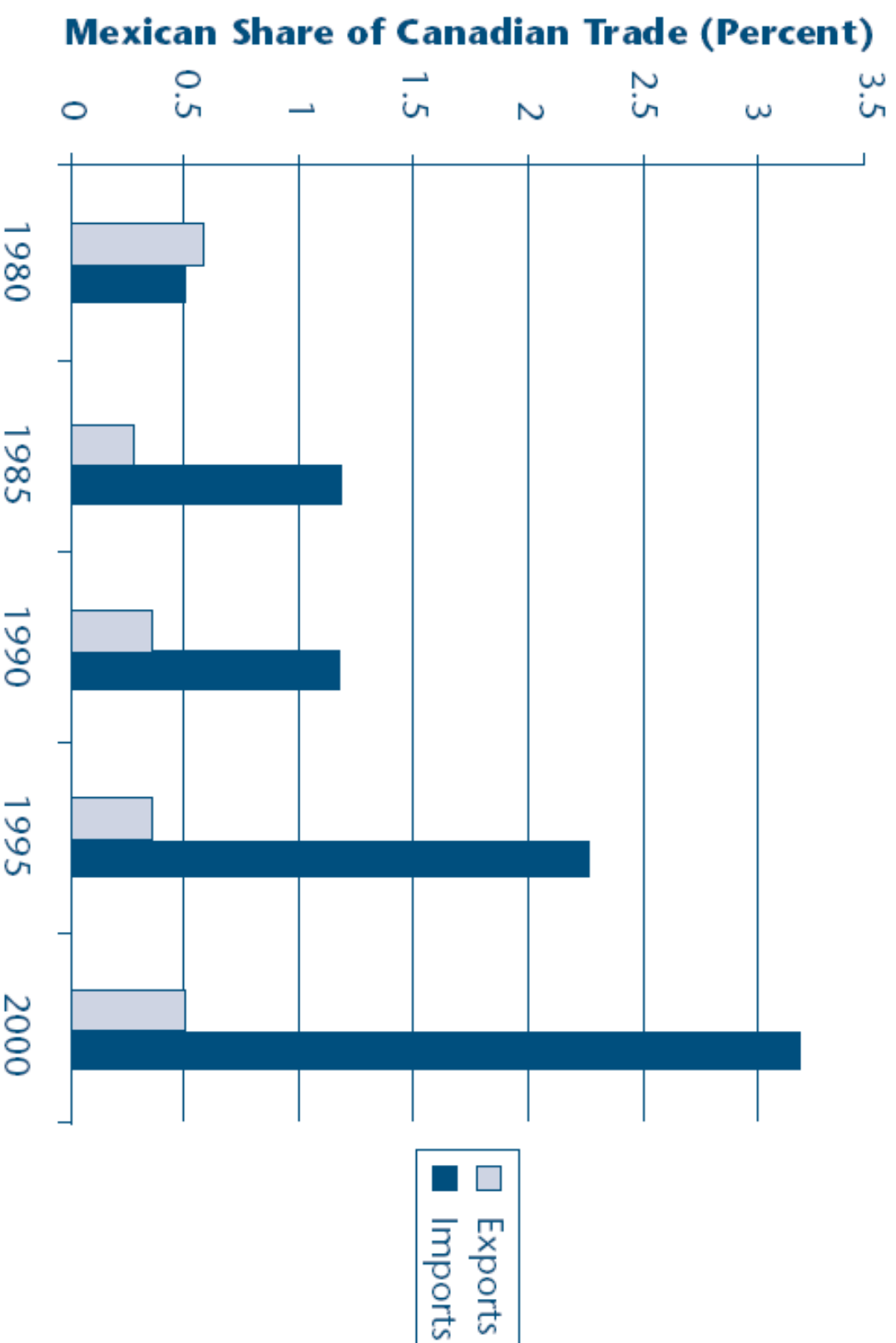
**Mexican Shares of U.S. Trade since 1980**



Source: IMF *Direction of Trade Statistics*, 2001.  
5-19

**Figure 5-5a**

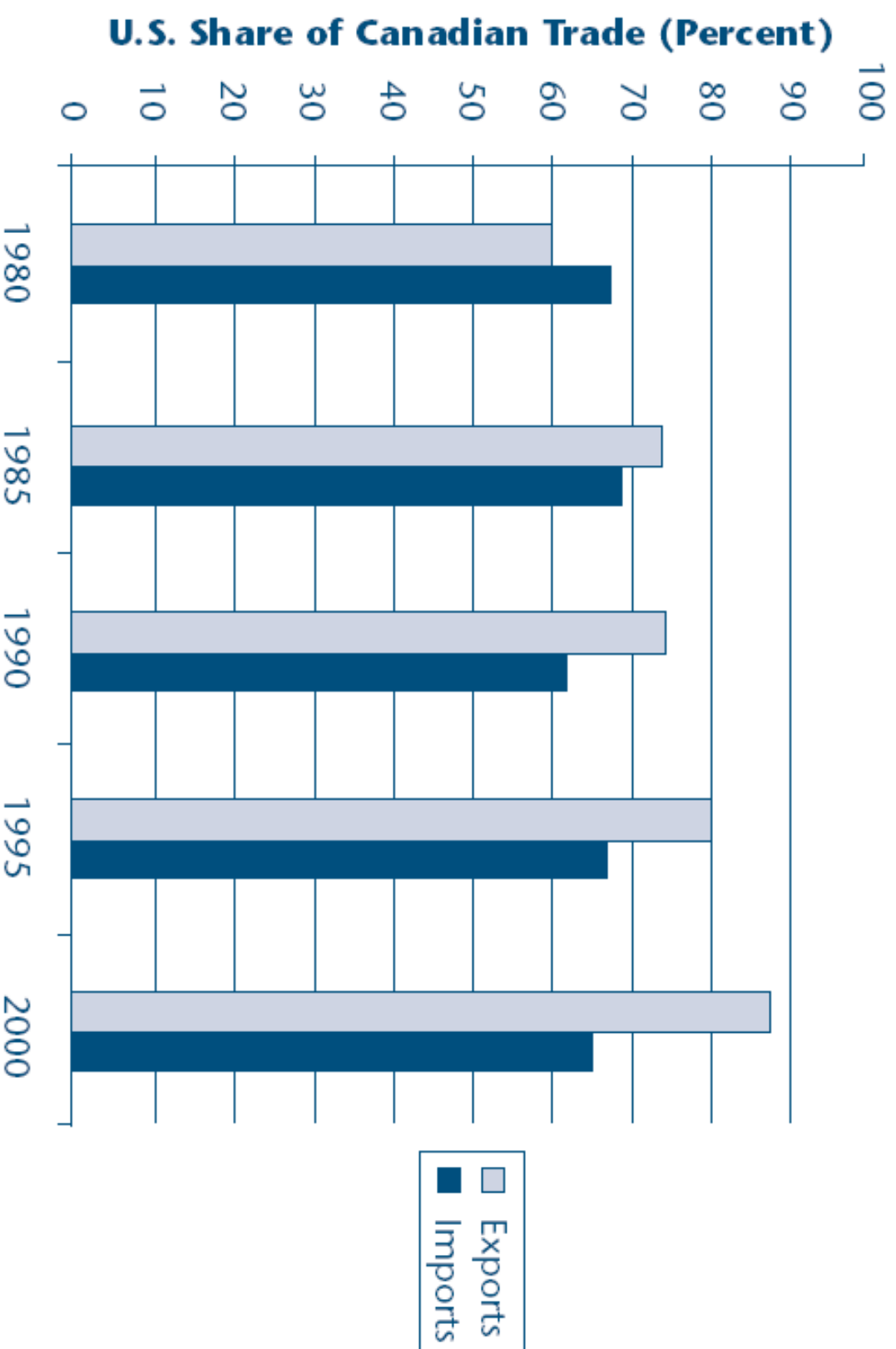
**Mexican Shares of Canadian Trade since 1980**



**Source:** IMF *Direction of Trade Statistics*, 2001.  
5-20

**Figure 5-5b**

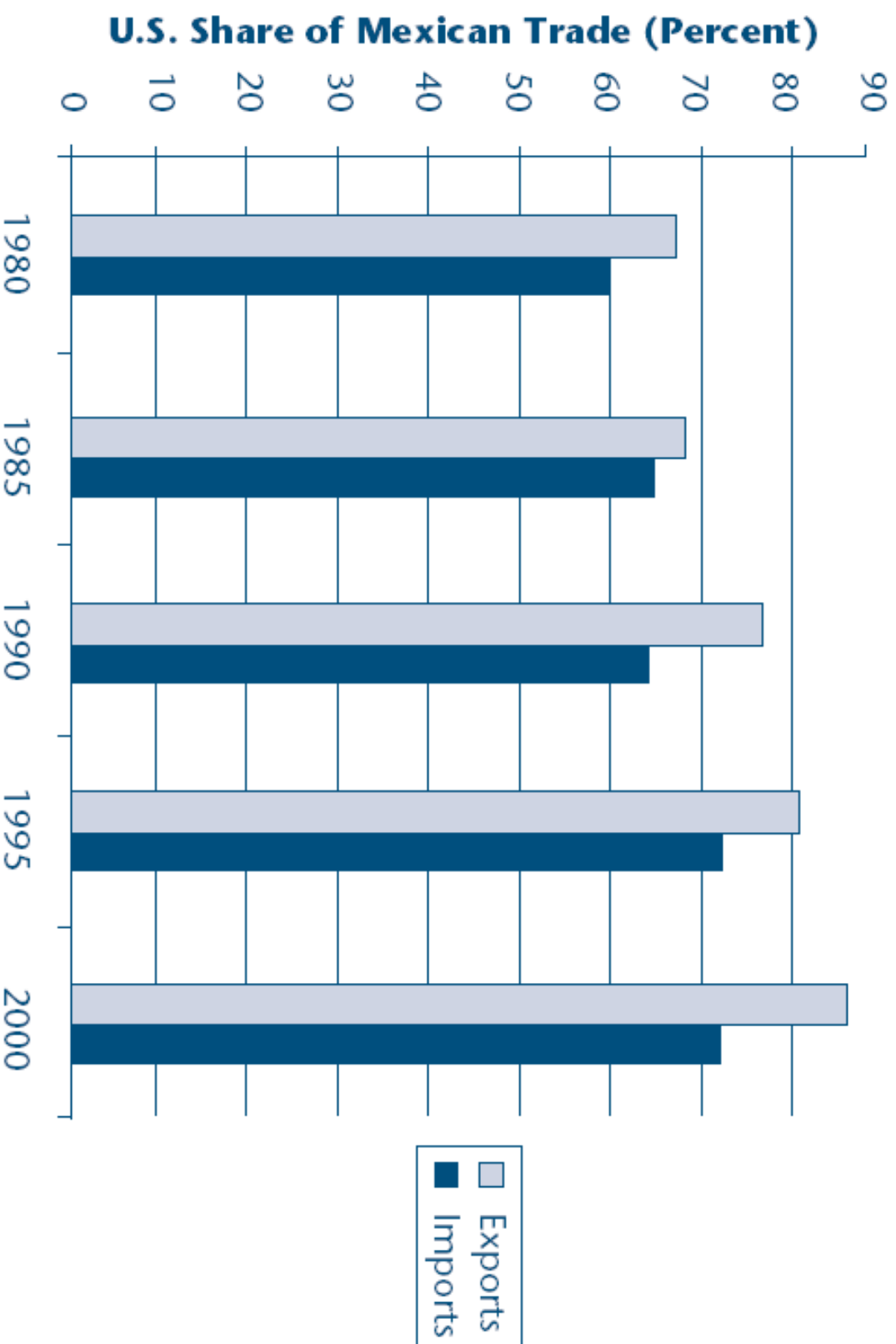
**U.S. Shares of Canadian Trade since 1980**



**Source:** IMF *Direction of Trade Statistics*, 2001.

**Figure 5-6a**

**U.S. Shares of Mexican Trade since 1980**



**Source:** IMF *Direction of Trade Statistics*, 2001.  
5-22

**Figure 5-6b**

**Canadian Shares of Mexican Trade since 1980**



**Source:** IMF *Direction of Trade Statistics*, 2001.  
5-23

# Customs Unions and Common Markets

- Customs Union
  - A group of countries that agree to treat themselves preferentially in trade, and commit themselves to adopting identical trade policies with respect to nations outside the customs union.
- The Treaty of Rome and the European Economic Community (1957)
  - Belgium, France, West Germany, Italy, Luxembourg, and the Netherlands formed a customs union for free trade among their group but imposed common restrictions on trade with other countries.

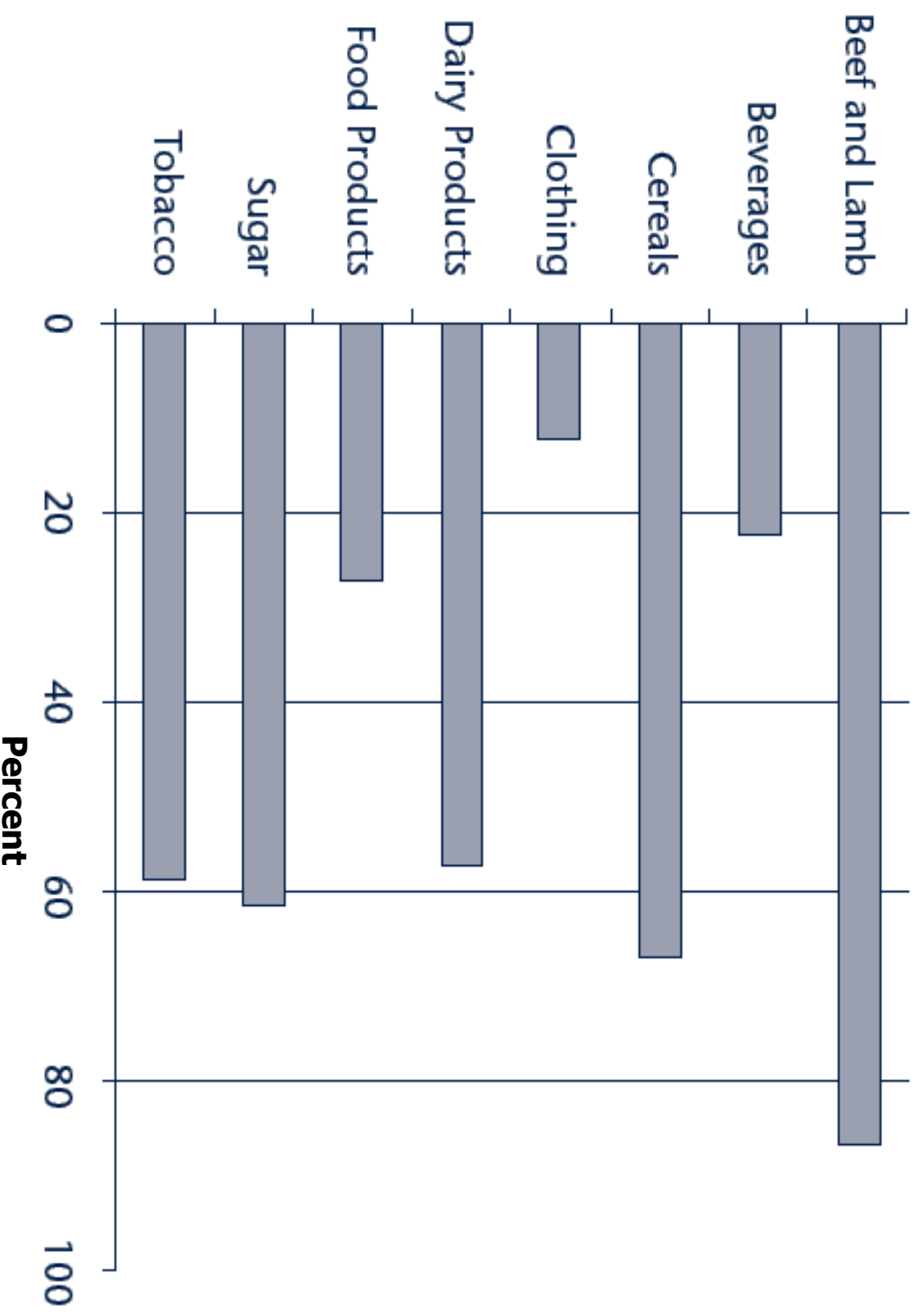


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**Figure 5-8a**

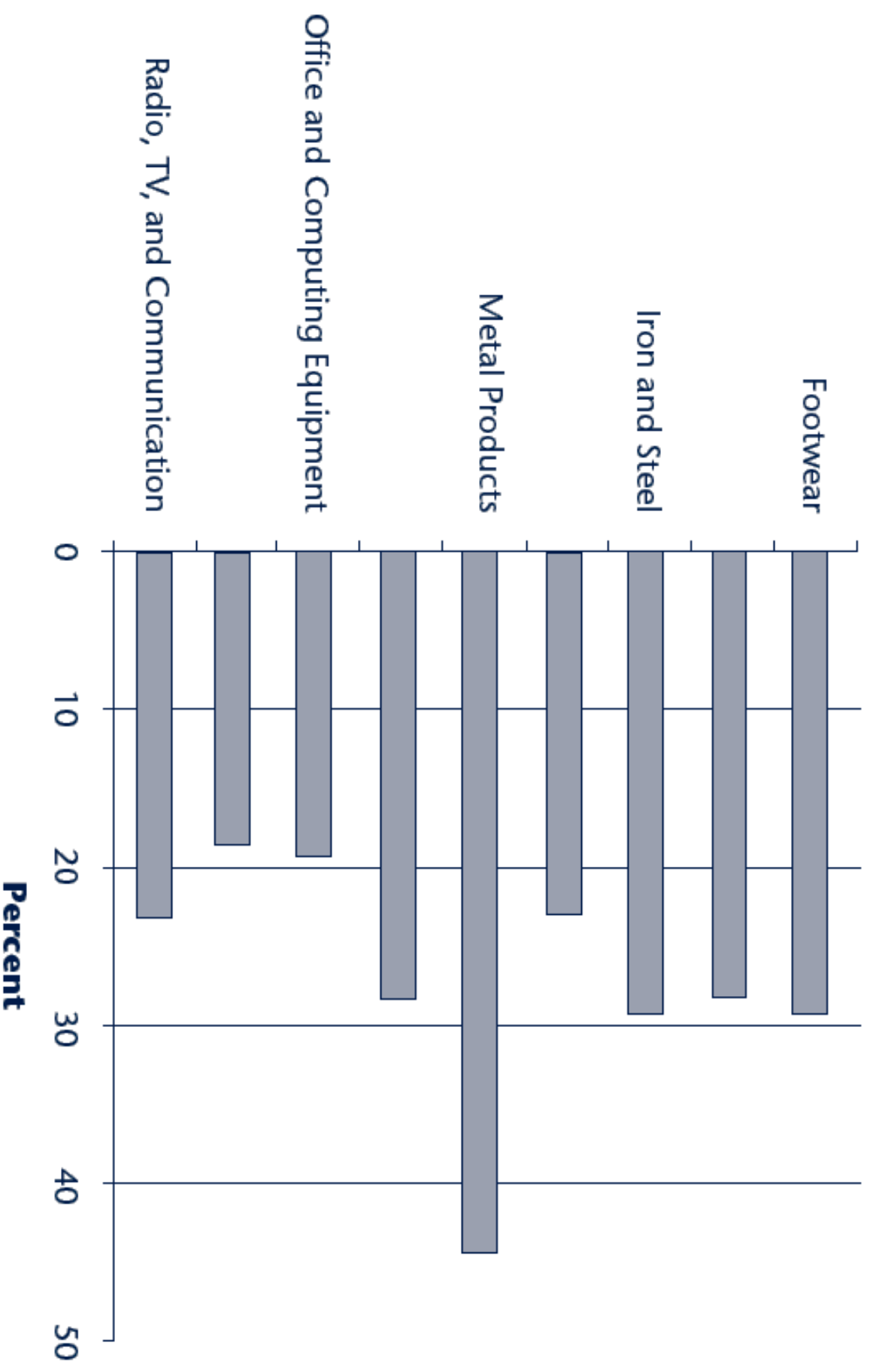
**Average Tariff Rates in the European Union**



**Source:** Patrick Messerlin, *Measuring the Costs of Protection in Europe*, Washington, D.C.: Institute for International Economics, 2000.

**Figure 5-8b**

**Average Anti-Dumping Rates in the European Union**



**Source:** Patrick Messerlin, *Measuring the Costs of Protection in Europe*, Washington, D.C.: Institute for International Economics, 2000.

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# Why do countries agree to integrate their economies?

- Political arguments
- Economic arguments

## The Economic Case for Integration

- Regional economic integration is an attempt to achieve additional gains from the free flow of trade and investment between countries beyond those attainable under international agreements such as the WTO
- Since it is easier to form an agreement with a few countries than across all nations, there has been a push toward regional economic integration

## The Political Case for Integration

- Politically, integration is attractive because
  - by linking countries together, making them more dependent on each other, and forming a structure where they regularly have to interact, the likelihood of violent conflict and war will decrease
  - by linking countries together, they have greater clout and are politically much stronger in dealing with other nations

# Impediments to Integration

- Integration is not easy to achieve or maintain
- There are two main impediments to integration
  1. it can be costly - while a nation as a whole may benefit from a regional free trade agreement, certain groups may lose
  2. it can result in a loss of national sovereignty

## Case Against Regional Integration

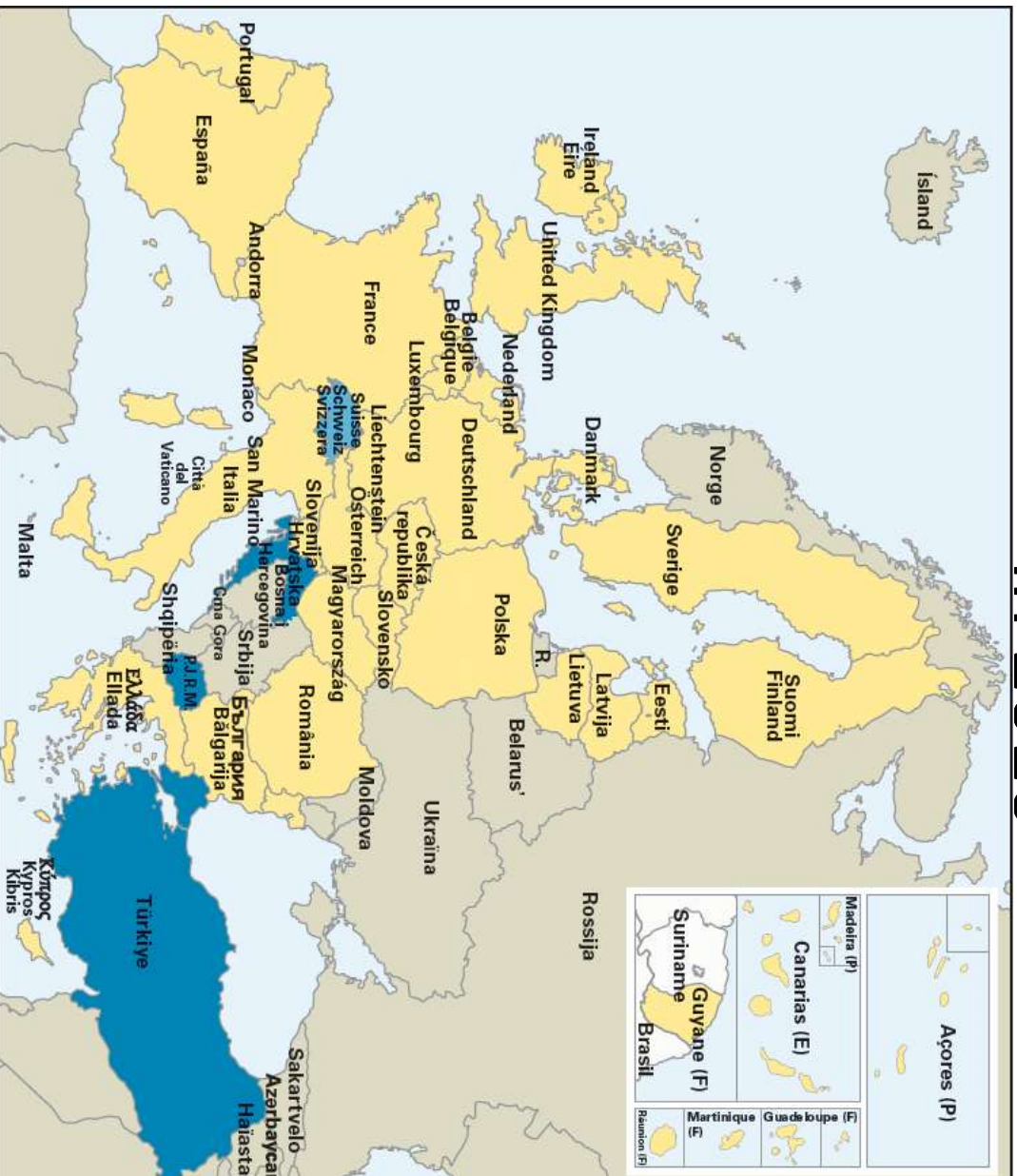
- Regional economic integration only makes sense when the amount of trade it creates exceeds the amount it diverts
- **Trade creation** occurs when low cost producers within the free trade area replace high cost domestic producers
- **Trade diversion** occurs when higher cost suppliers within the free trade area replace lower cost external suppliers



# Evolution of the European Union

- The **European Union (EU)** is the result of
  - the devastation of two world wars on Western Europe and the desire for a lasting peace
  - the desire by the European nations to hold their own on the world's political and economic stage
- The forerunner of the EU was the European Coal and Steel Community (formed in 1951)
- The Treaty of Rome established the European Economic Community in 1957
  - the name was changed to the EU in 1994

Map 8.1: Member States of the European Union  
in 2010



# Political Structure of the EU

- The four main institutions of the EU are
  1. the [European Commission](#) - proposes EU legislation, implements it, and monitors compliance
  2. the [European Council](#) - the ultimate controlling authority within the EU
  3. the [European Parliament](#) - debates legislation proposed by the commission and forwarded to it by the council
  4. the [Court of Justice](#) - the supreme appeals court for EU law

# The Single European Act

- The **Single European Act** (1987) committed EC countries to work toward establishment of a single market by 1992
- The Act proposed to
  - remove all frontier controls between EC countries
  - apply the principle of mutual recognition to product standards
  - open procurement to non-national suppliers
  - lift barriers to competition in retail banking and insurance
  - remove all restrictions on foreign exchange transactions between member countries
  - abolish restrictions on cabotage

# The Establishment of the Euro

- The **Maastricht Treaty** (1991) committed EU members to adopt a single currency, the euro
  - the euro is used by 16 of the 27 member states
  - created the euro zone, the second largest currency zone in the world after that of the U.S. dollar
  - countries that participate have agreed to give up control of their monetary policy
  - Britain, Denmark and Sweden have opted out of the euro zone

# The Establishment of the Euro

**Question:** What are the benefits of the euro?

**Answer:**

- handling one currency, rather than many
- easier to compare prices across Europe
- increased competition promotes greater efficiencies in production
- the pan-European capital market should further develop
- range of investment options open both to individuals and institutions should increase

# The Establishment of the Euro

**Question:** What are the costs of the euro?

- Membership implies a loss of control over monetary policy
  - The European Central Bank (ECB) was established to manage monetary policy, but some question its ability to act independently
- The EU is not an **optimal currency area** - an area where similarities in the underlying structure of economic activities make it feasible to adopt a single currency and use a single exchange rate as an instrument of macro-economic policy
  - countries may react differently to changes in the euro

## The Establishment of the Euro

- Since its establishment the euro has had a volatile trading history with the U.S. dollar
  - initially, the euro was valued at \$1.17, then fell in value relative to the dollar, but strengthened to an all-time high of \$1.54 in March 2008
  - in early 2010, the exchange rate was €1=\$1.35



## Enlargement of the European Union

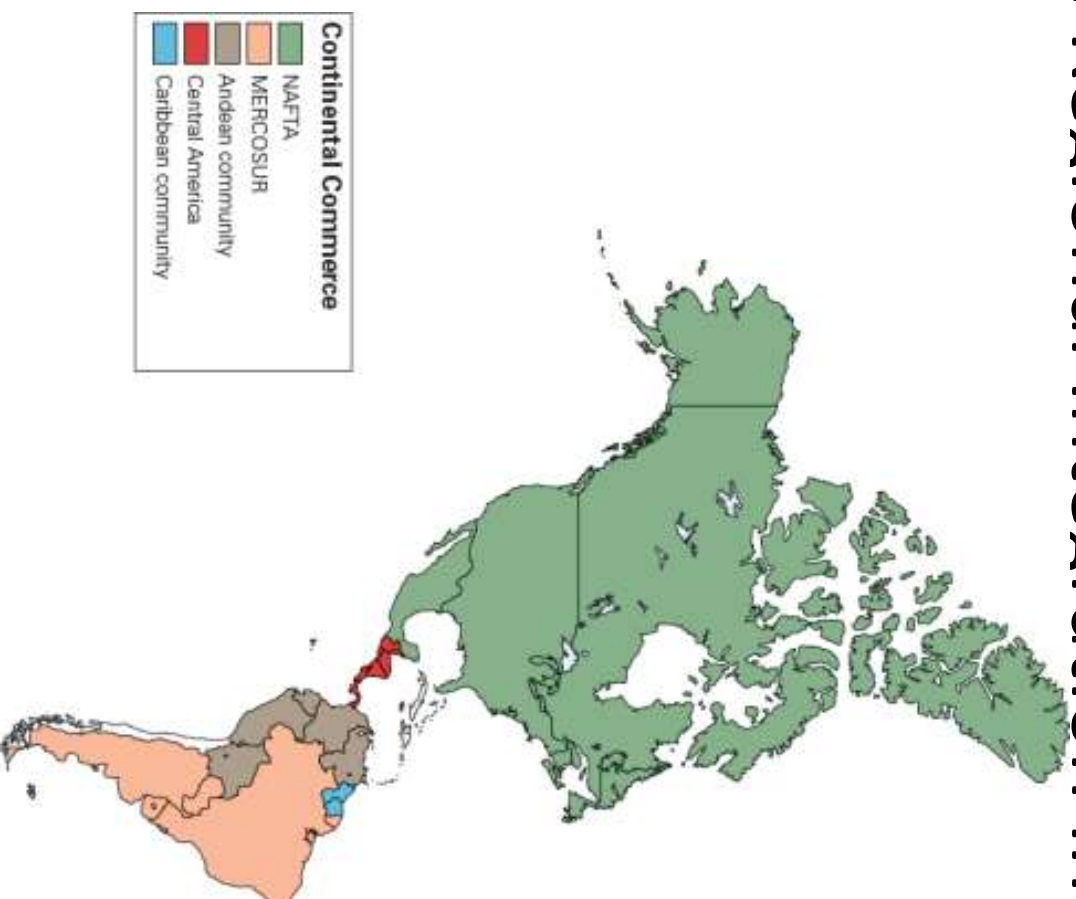
- Many countries, particularly from Eastern Europe, have applied for membership in the EU
- Ten countries joined in 2004 expanding the EU to 25 states, with population of 450 million people, and a single continental economy with a GDP of €11 trillion
- In 2007, Bulgaria and Romania joined bringing membership to 27 countries
- Turkey has also applied for membership, but is not expected to join until 2013, if at all

## Economic Integration in the Americas

- Regional economic integration is on the rise in the Americas
  - The most significant attempt is the North American Free Trade Agreement
- Other agreements include
  - the Andean Community
  - MERCOSUR
- There are also attempts to form a Free Trade Area of the Americas

# Economic Integration in the Americas

Map 8.2: Regional Integration in the Americas



# NAFTA

- The North American Free Trade Agreement (NAFTA) between the U.S., Canada, and Mexico became law in 1994 and
  - abolished tariffs on 99 percent of goods traded
  - removed barriers on the cross-border flow of services
  - protects intellectual property rights
  - allows each country to apply its own environmental standards
  - establishes two commissions to impose fines and remove trade privileges when environmental standards or legislation involving health and safety, minimum wages, or child labor are ignored

# NAFTA

Question: What are the benefits of NAFTA?

Answer:

- Mexico
  - increased jobs as low cost production moves south and more rapid economic growth
- The U.S. and Canada
  - access to a large and increasingly prosperous market and lower prices for consumers from goods produced in Mexico
  - U.S. and Canadian firms with production sites in Mexico are more competitive on world markets

# NAFTA

**Question:** What are the drawbacks of NAFTA?

**Answer:**

- Jobs could be lost and wage levels could decline in the U.S. and Canada
- Mexican workers could emigrate north
- Pollution could increase due to Mexico's more lax standards
- Mexico would lose its sovereignty

# NAFTA

Question: How successful has NAFTA been?

Answer:

- Studies of NAFTA's early impact suggest that both advocates and detractors may have been guilty of exaggeration
  - trade between the three countries has increased by 250 percent
  - the members have become more integrated
  - productivity has increased in member nations
  - employment effects have been small
  - Mexico has become more politically stable

## NAFTA

**Question:** Should NAFTA accept new members?

**Answer:**

- Several other Latin American countries have indicated their desire to eventually join NAFTA
- Currently both Canada and the U.S. are adopting a wait and see attitude with regard to most countries



# The Andean Community

- The **Andean Pact** (1969) was based on the EU model
  - the agreement had more or less failed by the mid-1980s
- In the late 1980s, Latin American governments began to adopt free market economic policies
- In 1990, the Andean Pact was re-launched, and now operates as a customs union
- In 2003, it signed an agreement with MERCOSUR to restart negotiations towards the creation of a free trade area
  - current members include Bolivia, Ecuador, Peru, and Columbia

# MERCOSUR

- **MERCOSUR** (1988) - a free trade pact between Brazil and Argentina
  - in 1990, it was expanded to include Paraguay and Uruguay
- MERCOSUR has been successful at reducing trade barriers between member states
- However, critics worry that MERCOSUR is diverting trade rather than creating trade, and local firms are investing in industries that are not competitive on a worldwide basis
  - current members include Brazil, Argentina, Paraguay, Uruguay, and Venezuela

## Other Trade Pacts in the Americas

- Two other trade pacts in the Americas are

### 1. the Central American Common Market

- Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and the Dominican Republic
- these countries were joined by the U.S. in 2003 to create a free trade agreement, the Central American Free Trade Agreement (2003)

### 2. CARICOM (1973), a customs union between English-speaking Caribbean countries

- six members formed the Caribbean Single Market and Economy (CSME) in 2006 to lower trade barriers and harmonize macro-economic and monetary policy

## Free Trade of the Americas

- Talks began in 1998 to establish a **Free Trade of The Americas (FTAA)** by 2005
- The FTAA was not established as planned
- Current support for the agreement by the U.S. and Brazil is limited
- If the FTAA is established, it would create a free trade area of nearly 800 million people

## Economic Integration Elsewhere

- There have been various attempts at regional economic integration throughout Asia and Africa
- The success of these attempts have been limited
- The most significant efforts are the Association of Southeast Asian Nations and the Asia-Pacific Economic Cooperation

# ASEAN

- The *Association of Southeast Asian Nations (ASEAN)* (1967) - foster freer trade between member countries and to achieve some cooperation in their industrial policies
  - Brunei, Indonesia, Malaysia, the Philippines, Singapore, Thailand, Vietnam, Myanmar, Laos, and Cambodia
- An *ASEAN Free Trade Area (AFTA)* (2003) between the six original members of ASEAN came into full effect to reduce import tariffs among members
  - Vietnam, Laos, and Myanmar have all joined

## Asia-Pacific Economic Cooperation

- **Asian Pacific Economic Cooperation (APEC)** was founded in (1990) to increase multilateral cooperation in view of the economic rise of the Pacific nations and the growing interdependence within the region
  - APEC currently has 21 members including the United States, Japan, and China

## Regional Trade Blocs in Africa

- There are nine trade blocs on the African continent
- However progress toward the establishment of meaningful trade blocs has been slow
- Many countries believe that they need to protect their industries from unfair foreign competition making it difficult to create free trade areas or customs unions



# Implications for Managers

**Question:** Why is regional economic integration important to international companies?

**Answer:**

- Regional economic integration means that markets that had been protected from foreign competition are increasingly open
  - these developments are particularly significant in the European Union and NAFTA
- However, regional economic integration is likely to increase competition

## Opportunities

- Formerly protected markets are now open to exports and direct investment
- The free movement of goods across borders, the harmonization of product standards, and the simplification of tax regimes mean that firms can realize potentially enormous cost economies by centralizing production in those locations where the mix of factor costs and skills is optimal

## Threats

- Lower trade and investment barriers could lead to increased price competition within the EU and NAFTA
  - increased competition within the EU is forcing EU firms to become more efficient, and stronger global competitors
- Firms outside the blocs risk being shut out of the single market by the creation of a “trade fortress”
  - firms may be limited in their ability to pursue the strategy of their choice if the EU intervenes and imposes conditions on companies proposing mergers and acquisitions