Chapter Nine

Regional Economic Integration

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International Business, 6/e
Adapted by R. Helg for LIUC 2008

Introduction

After the II WW there have been two major approaches to trade liberalization:

- The **multilateral-non discriminatory approach** (GATT-WTO)
- The **discriminatory approach**
  (Preferential or Regional Trade agreements)

Notwithstanding their differences, these two approaches managed to cohabit well for a long period (GATT allows various exception to the non-discrimination principle).

Is this now finished?

Introduction

- One notable trend in the global economy in recent years has been the accelerated movement toward regional economic integration
  - Regional economic integration refers to agreements among countries in a geographic region to reduce, and ultimately remove, tariff and non-tariff barriers to the free flow of goods, services, and factors of production between each other

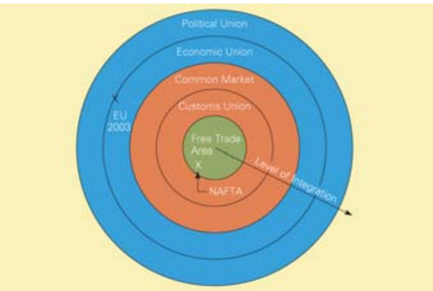
Levels of Economic Integration

- In a **Free Trade Area** all barriers to the trade of goods and services among member countries are removed
- A **Customs Union** eliminates trade barriers between member countries and adopts a common external trade policy
- A **Common Market** has no barriers to trade between member countries, includes a common external trade policy, and allows factors of production to move freely between members

Levels of Economic Integration

- An **Economic Union** involves the free flow of products and factors of production between member countries and the adoption of a common external trade policy, but it also requires a common currency, harmonization of members' tax rates, and a common monetary and fiscal policy
- A **Political Union** occurs when a central political apparatus coordinates the economic, social, and foreign policy of the member states

Levels of Economic Integration



The Economic Case for Integration

- Stimulates economic growth in countries
- Increases FDI and world production
- Countries specialize in those goods and services efficiently produced
- Additional gains from free trade beyond the international agreements such as GATT and WTO

The Political Case for Integration

- Economic interdependence creates incentives for political cooperation
  - This reduces potential for violent confrontation
- Together, the countries have more economic clout to enhance trade with other countries or trading blocs

Impediments to Integration

- Integration is hard to achieve and sustain
  - Nation may benefit but groups within countries may be hurt
  - Potential loss of sovereignty and control over domestic issues

The Case Against Regional Integration

- Economists point out that the benefits of regional integration are determined by the extent of trade creation, as opposed to trade diversion
  - **Trade creation** occurs when high cost domestic producers are replaced by low cost producers within the free trade area
  - **Trade diversion** occurs when lower cost external suppliers are replaced by higher cost suppliers within the free trade area

Regional Economic Integration in Europe

- Europe has two trade blocks
  - European Union
    - Seen as the emerging power with 27 members
  - European Free Trade Association
    - Has only four members

Evolution of the European Union

- Product of two political factors:
  - Devastation of WWI and WWII and desire for peace
  - Desire for European nations to hold their own, politically and economically, on the world stage
- 1951 - European Coal and Steel Community.
- 1957- Treaty of Rome establishes the European Community
- 1994 - Treaty of Maastricht changes name to the European Union

27 European Union members 2007

Political Structure of the European Union

- **European Council**
  - Heads of state and commission
  - President resolves policy issues and sets policy direction
- **European Commission**
  - 26 Commissioners appointed by members for 4 year terms
  - Proposing, implementing, and monitoring legislation

Political Structure of the European Union

- **European Parliament**
  - 630 directly elected members
  - Propose amendments to legislation, veto power over budget and single-market legislation, appoint commissioners
- **Court of Justice**
- **Council of Ministers**

The Single European Act

- This act committed member countries to work toward the establishment of a single market by December 31, 1992
- The act was born out of:
  - Frustration among members of the European Community regarding the barriers to the free flow of trade and investment between member countries
  - A need to harmonize the wide range of technical and legal standards for doing business

The Single European Act

- The Delors Commission proposed that all impediments to the formation of a single market be eliminated
  - The act was independently ratified by the parliaments of each member country and became law in 1987

The Single European Act

- Objectives:
  - Remove frontier controls
  - "Mutual recognition" of product standards
  - Open public procurement to non nationals
  - Lift barriers to banking and insurance competition
  - Remove restrictions on foreign exchange transactions
  - Abolish cabotage restrictions

The Euro

- **Benefits:**
  - Savings from using only one currency
  - Easy to compare prices, resulting in lower prices
  - Forces efficiency and slashing costs
  - Creates liquid pan-Europe capital market
  - Increases range of investments for individuals and institutions
  - As of 2007, Euro strong against the dollar and expected to rise
- **Costs:**
  - Countries lose monetary policy control
  - European Central Bank controls policy for the "Euro zone"
  - EU is not an "*optimal currency area*"
  - Country economies are different
  - Euro puts the economic cart before the political horse
  - Strong Euro (2006) makes it harder for Euro zone exporters to sell their goods

Enlargement of the European Union

- One major issue facing the EU over the past few years has been that of enlargement
  - Has become a possibility since the collapse of communism at the end of the 1980's
  - By the end of the 1990's 13 countries had applied to become EU members
- In December 2002 the EU formally agreed to accept the applications of 10 countries, which resulted in:
  - The EU expanding to include 25 states
  - The addition of 75 million citizens to the EU
  - Created a single continental economy with a GDP close to 11 trillion Euros

Enlargement of the European Union

- To qualify for EU membership applicants must:
  - Privatize state assets
  - Deregulate markets
  - Restructure industries
  - Tame inflation
  - Enshrine complex EU laws into their own systems
  - Establish stable democratic governments
  - Respect human rights

The North American Free Trade Agreement

- The North American Free Trade Agreement (NAFTA) was ratified by the governments of the United States, Canada, and Mexico in 1993; it became law January 1, 1994
- The contents of NAFTA includes the following
  - Over 10 year period: tariffs reduced (99% of goods traded)
  - Removal of most barriers on cross border flow of services
  - Removal of restrictions on FDI except in certain sectors
    - Mexican railway and energy
    - US airline and radio communications
    - Canadian culture

The North American Free Trade Agreement

- NAFTA contents continued:
  - Protection of intellectual property rights
  - Applies national environmental standards
  - Establishment of commission to police violations

The Case For and Against NAFTA

- Pros
  - Enlarged and productive regional base
  - Labor-intensive industries move to Mexico
  - Mexico gets investment and employment
  - Increased Mexican income to buy US/Canada goods
  - Demand for goods increases jobs
  - Consumers get lower prices
- Cons
  - Loss of jobs to Mexico
  - Mexican firms have to compete against efficient US/Canada firms
  - Mexican firms become more efficient
  - Environmental degradation
  - Loss of national sovereignty

NAFTA Results

- Recent surveys indicate that NAFTA's overall impact has been small but positive
  - From 1993 to 2004, trade between NAFTA's partners grew by 250 percent
  - Canada's trade with NAFTA partners increased from 70% to more than 80% of all Canadian foreign trade
  - Mexico's trade with NAFTA partners increased from 66% to 80% of all Mexican foreign trade

NAFTA Results

- All countries experienced strong productivity growth
- The United States has lost 110,000 jobs per year due to NAFTA
  - Many economists dispute this figure because more than 2 million jobs a year were created in the US during the same time period
- The most significant impact of NAFTA has not been economic, but political
  - NAFTA helped create the background for increased political stability in Mexico

The Andean Community

- Bolivia, Chile, Ecuador, Colombia, and Peru signed an agreement in 1969 to create the Andean Pact
- The Andean Pact was largely based on the EU model, but was far less successful at achieving its stated goals
- By the mid-1980s, the Andean Pact had all but collapsed and had failed to achieve any of its stated objectives
- Nearly failed. Rejuvenated in 1990 in the Galapagos Declaration
  - Five current members include Bolivia, Ecuador, Peru, Colombia, and Venezuela
  - Objectives included the establishment of a free trade area by 1992, a customs union by 1994, and common market by 1995
- Operates as a customs union currently

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Mercosur

- Originated in 1988 as a free trade pact between Brazil and Argentina
- The pact expanded in March 1990 to include Paraguay and Uruguay
- These countries have:
  - A combined population of 200 million
  - An average annual growth rate of 3.5% for GDP
- MERCOSUR countries have significant trade diversion issues

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Other Hemisphere Associations

- Central American Common Market
  - 1960s: Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua.
  - Collapsed in 1969
- CARICOM
  - 1973: English-speaking Caribbean countries
  - 1991: Failed for third time to establish common external tariff
- Free Trade Area of the Americas
  - Talks scheduled for January 2005 did not occur
  - Two stumbling blocks include intellectual property rights and reductions in agriculture subsidies

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Association of Southeast Asian Nations (ASEAN)

- Created in 1967
- Objective to achieve free trade between member countries and achieve cooperation in their industrial
- Brunei, Cambodia, Indonesia, Laos, Malaysia, the Philippines, Myanmar, Singapore, Thailand, and Vietnam
- Progress limited by Asian financial crisis of the 90's

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ASEAN Countries

Asia Pacific Economic Cooperation APEC

- Founded in 1990 to ‘promote open trade and practical economic cooperation’
  - ‘Promote a sense of community’
  - 21 members
  - 60% of world’s GNP
  - 47% of global trade
- Despite slow progress, if successful, could become the world’s largest free trade area

APEC Countries

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Regional Trade Blocs in Africa

- African countries have been experimenting with regional trade blocs for half a century; there are now 9 trade blocs on the continent
- Progress toward the establishment of meaningful trade blocs has been slow
- In 2001 Kenya, Uganda, and Tanzania committed themselves to relaunching the East African Community trade bloc 24 years after it collapsed
  - The intent is to establish a customs union, regional court, legislative assembly, and a political federation

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Implications for Managers

- Opportunities: Creation of single markets
  - Protected markets, now open
  - Lower costs doing business in single market
- Threats:
  - Differences in culture and competitive practices make realizing economies of scale difficult
  - More price competition
  - Outside firms shut out of market
  - EU intervention in mergers and acquisitions

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Looking Ahead to Chapter 10

- The Foreign Exchange Market
  - The functions of the foreign exchange market
  - The nature of the foreign exchange market
  - Economic theories of exchange rate determination
  - Exchange rate forecasting
  - Currency convertibility
  - Implications for managers

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