# International Business
8e

By Charles W.L. Hill
adapted for LIUC 2010 by R.Helg

Chapter 8

## Regional Economic Integration

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## 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?

8-3

## What is Regional Economic Integration?

- **Regional economic integration** - agreements between countries in a geographic region to reduce tariff and non-tariff barriers to the free flow of goods, services, and factors of production between each other
- **Question:** Do regional trade agreements promote free trade?
  - In theory, yes, but the world may be moving toward a situation in which a number of regional trade blocks compete against each other

8-4

## What are the levels of regional economic integration?

1. A **free trade area** eliminates all barriers to the trade of goods and services among member countries
   - **European Free Trade Association** (**EFTA**) - Norway, Iceland, Liechtenstein, and Switzerland
   - **North American Free Trade Agreement** (**NAFTA**) - U.S., Canada, and Mexico
   - **ASEAN Free Trade Agreement** (AFTA) - between South East Asian countries
2. A **customs union** eliminates trade barriers between member countries and adopts a common external trade policy
   - **Andean Pact** (Bolivia, Columbia, Ecuador and Peru)
3. A **common market** has no barriers to trade between member countries, a common external trade policy, and the free movement of the factors of production
   - **MERCOSUR** (Brazil, Argentina, Paraguay, and Uruguay)

8-5

## What are the levels of regional economic integration?

4. An **economic union** has the free flow of products and factors of production between members, a common external trade policy, a common currency, a harmonized tax rate, and a common monetary and fiscal policy
   - **European Union** (**EU**)
5. A **political union** involves a central political apparatus that coordinates the economic, social, and foreign policy of member states
   - The EU is headed toward at least partial political union, and the United States is an example of even closer political union

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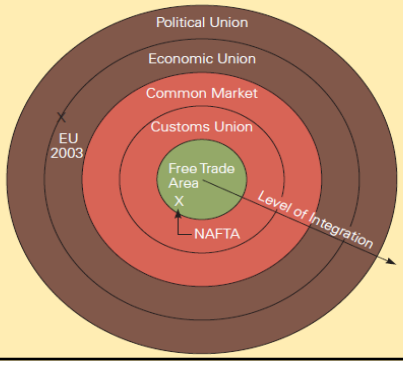
## What are the levels of regional economic integration?




## Why should countries integrate their economies?

- All countries gain from free trade and investment - regional economic integration is an attempt to exploit the gains from free trade and investment
- Linking countries together, making them more dependent on each other
  - creates incentives for political cooperation and reduces the likelihood of violent conflict
  - gives countries greater political clout when dealing with other nations

8-8

## What limits efforts at integration?

- Economic integration can be difficult because
  - while a nation as a whole may benefit from a regional free trade agreement, certain groups may lose
  - it implies a loss of national sovereignty
- Regional economic integration is only beneficial if 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

8-9

## What is the status of regional economic integration in Europe?

- Europe has two trade blocs

1. The **European Union** (**EU**) with 27 members
2. The **European Free Trade Area** (**EFTA**) with 4 members

- The EU is seen as the world's next economic and political superpower

8-10

## What is the status of regional economic integration in Europe?

**Member States of The European Union in 2010**

## What is the European Union?

- The devastation of two world wars on Western Europe prompted the formation of the EU
  - Members wanted lasting peace and to hold their own on the world's political and economic stage
- Forerunner was the European Coal and Steel Community (1951)
- The European Economic Community (1957) was formed at the **Treaty of Rome** with the goal of becoming a common market
- The **Single European Act** (1987)
  - committed the EC countries to work toward establishment of a single market by December 31, 1992
  - was born out of frustration among EC members that the community was not living up to its promise
  - provided the impetus for the restructuring of substantial sections of European industry allowing for faster economic growth than would otherwise have been the case

8-12

## What is the political structure of the European Union?

- The **European Council** - resolves major policy issues and sets policy directions
- The **European Commission** - responsible for implementing aspects of EU law and monitoring member states to ensure they are complying with EU laws
- The **Council of the European Union** - the ultimate controlling authority within the EU
- The **European Parliament** - debates legislation proposed by the commission and forwarded to it by the council
- The **Court of Justice** - the supreme appeals court for EU law

8-13

## What is the Euro?

- The **Maastricht Treaty** committed the EU to adopt a single currency
  - created the second largest currency zone in the world after that of the U.S. dollar
  - used by 16 of the 27 member states
  - Britain, Denmark and Sweden opted out
- since its establishment January 1, 1999, the euro has had a volatile trading history with the U.S. dollar

8-14

## Is the euro a good thing?

- Benefits of the euro
  - savings from having to handle one currency, rather than many
  - it is easier to compare prices across Europe, so firms are forced to be more competitive
  - gives a strong boost to the development of highly liquid pan-European capital market
  - increases the range of investment options open both to individuals and institutions
- Costs of the euro
  - loss of control over national monetary policy
  - EU is not an **optimal currency area**

8-15

## Should the EU continue to expand?

- Many countries have applied for EU membership
- Ten countries joined in 2004 expanding the EU to 25 states
- In 2007, Bulgaria and Romania joined bringing membership to 27 countries
- Turkey has been denied full membership because of concerns over human rights

8-16

## What is the status of economic integration in the Americas?

- There is a move toward greater regional economic integration in the Americas
- The biggest effort is the North American Free Trade Area (NAFTA)
- Other efforts include the Andean Community and MERCOSUR
- A hemisphere-wide Free Trade of the Americas is under discussion

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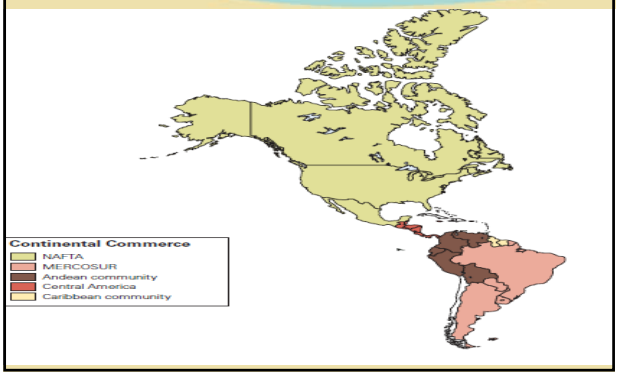
## What is the status of economic integration in the Americas?



## What is the North American Free Trade Agreement?

- The **North American Free Trade Area** (**NAFTA**, 1994)
  - includes the United States, Canada, and Mexico
  - abolished tariffs on 99% of the goods traded between members
  - removed most barriers on the cross-border flow of services
  - protects intellectual property rights
  - removes most restrictions on FDI between the three member countries
  - 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

8-19

## Is the North American Free Trade Area beneficial?

- Supporters of NAFTA claimed that
- Mexico would benefit
  - from increased jobs as low cost production moves south and will see more rapid economic growth as a result
- the U.S. and Canada would benefit from
  - access to a large and increasingly prosperous market
  - the lower prices for consumers from goods produced in Mexico
  - low cost labor and the ability to be more competitive on world markets

8-20

## Is the North American Free Trade Area beneficial?

- Critics of NAFTA claimed that
  - jobs would be lost and wage levels would decline in the U.S. and Canada
  - Mexican workers would emigrate north
  - pollution would increase due to Mexico's more lax standards
  - Mexico would lose its sovereignty

8-21

## Who was right?

- Research indicates that NAFTA's early impact was subtle, and both advocates and detractors may have been guilty of exaggeration
- NAFTA is credited with helping create increased political stability in Mexico
- Other Latin American countries would like to join NAFTA

8-22

## What is the Andean Community?

- The **Andean Pact**
  - formed in 1969 using the EU model
  - had more or less failed by the mid-1980s
  - was re-launched in 1990, and now operates as a customs union
  - signed an agreement in 2003 with MERCOSUR to restart negotiations towards the creation of a free trade area

8-23

## What is MERCOSUR?

- **MERCOSUR**
  - originated in 1988 as a free trade pact between Brazil and Argentina
  - was expanded in 1990 to include Paraguay and Uruguay
  - may be diverting trade rather than creating trade, and local firms are investing in industries that are not competitive on a worldwide basis
  - initially made progress on reducing trade barriers between member states, but more recently efforts have stalled

8-24

## What is the Central American Trade Agreement and CARICOM?

- There are two other trade pacts in the Americas
  - the **Central American Trade Agreement** –(**CAFTA**, 2005) - to lower trade barriers between the U.S. and members
  - **CARICOM** (1973) - to establish a customs union
- Neither pact has achieved its goals yet
- In 2006, six CARICOM members formed the **Caribbean Single Market and Economy** (**CSME**) - to lower trade barriers and harmonize macro-economic and monetary policy between members

8-25

## What is Free Trade of the Americas?

- Talks began in April 1998 to establish a **Free Trade of The Americas** (**FTAA**) by 2005
- The FTAA was not established and now support from the U.S. and Brazil is mixed
  - the U.S. wants stricter enforcement if intellectual property rights
  - Brazil and Argentina want the U.S. to eliminate agricultural subsidies and tariffs
- If the FTAA is established, it will have major implications for cross-border trade and investment flows within the hemisphere
  - would create a free trade area of 850 million people who accounted for nearly $18 trillion in GDP in 2008

8-26

## What is the status of economic integration in Asia?

- Various efforts at integration have been attempted in Asia, but most exist in name only
  - **Association of Southeast Asian Nations** (**ASEAN**)
  - **Asia-Pacific Economic Cooperation** (**APEC**)

8-27

## What is the Association of Southeast Asian Nations?

- The **Association of Southeast Asian Nations** (**ASEAN**, 1967)
  - currently includes Brunei, Indonesia, Malaysia, the Philippines, Singapore, Thailand, Vietnam, Myanmar, Laos, and Cambodia
  - wants to foster freer trade between member countries and to achieve some cooperation in their industrial policies
- An **ASEAN Free Trade Area** (**AFTA**) between the six original members of ASEAN came into effect in 2003
  - In January 2010, ASEAN and China signed an FTA to create **ACFTA** a free trade area of 1,9 billion people

8-28

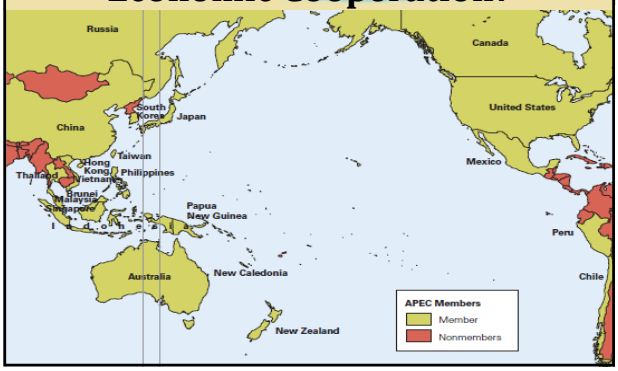
## What is the Association of Southeast Asian Nations?

## What is the Asia-Pacific Economic Cooperation?

- The **Asia-Pacific Economic Cooperation** (**APEC**)
  - has 21 members including the United States, Japan, and China
  - wants to increase multilateral cooperation
  - member states account for 55% of world's GNP, and 49% of world trade

8-30

## What is the Asia-Pacific Economic Cooperation?




## What is the Status of Economic Integration in Africa?

- Many countries are members of more than one of the nine blocs in the region
- But, since many countries support the use of trade barriers to protect their economies from foreign competition, meaningful progress is slow
- The **East African Community** (**EAC**) was re-launched in 2001, however so far, the effort appears futile

8-32

## What does Economic Integration Mean for Managers?

- Regional economic integration
  - opens new markets
  - allows firms to realize cost economies by centralizing production in those locations where the mix of factor costs and skills is optimal
- But
  - within each grouping, the business environment becomes competitive
  - there is a risk of being shut out of the single market by the creation of a "trade fortress"

8-33

## Review Question

All barriers to the free flow of goods and services between member countries are removed, and a common policy toward nonmembers is established in a

a) Free trade area
b) Customs union
c) Common market
d) Economic union

8-34

## Review Question

NAFTA is an example of a(n)

a) Free trade area
b) Customs union
c) Common market
d) Economic union

8-35

## Review Question

When higher cost suppliers within the free trade area replace lower cost external suppliers

a) The bloc as a whole benefits
b) There is trade creation
c) There is trade diversion
d) External suppliers benefit

8-36

## Review Question

_____ is the ultimate decision making body of the European Union.

a) Council of the European Union
b) European Parliament
c) Court of Justice
d) European Commission

8-37

## Review Question

_____ is responsible for proposing EU legislation.

a) Council of the European Union
b) European Parliament
c) Court of Justice
d) European Commission

8-38

## Review Question

Which of the following is *not* true of NAFTA?

a) It created a free trade area of nearly 800 million people
b) It created the background for increased political stability in Mexico
c) Several other Latin American countries have indicated their desire to eventually join NAFTA
d) Its participants are the United States, Canada, and Mexico

8-39