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Chapter 8

Regional Economic Integration

Introduction

- Regional economic integration refers to 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
- In theory, regional economic integration benefits all members
- Over the last two decades, the number of regional trade agreements has been on the rise

Introduction

Question: Is regional economic integration a good thing?

- While regional trade agreements are designed to promote free trade, there is some concern that the world is moving toward a situation in which a number of regional trade blocks compete against each other
- If this scenario materializes, the gains from free trade within blocs could be offset by a decline in trade between blocs

Levels of Economic Integration

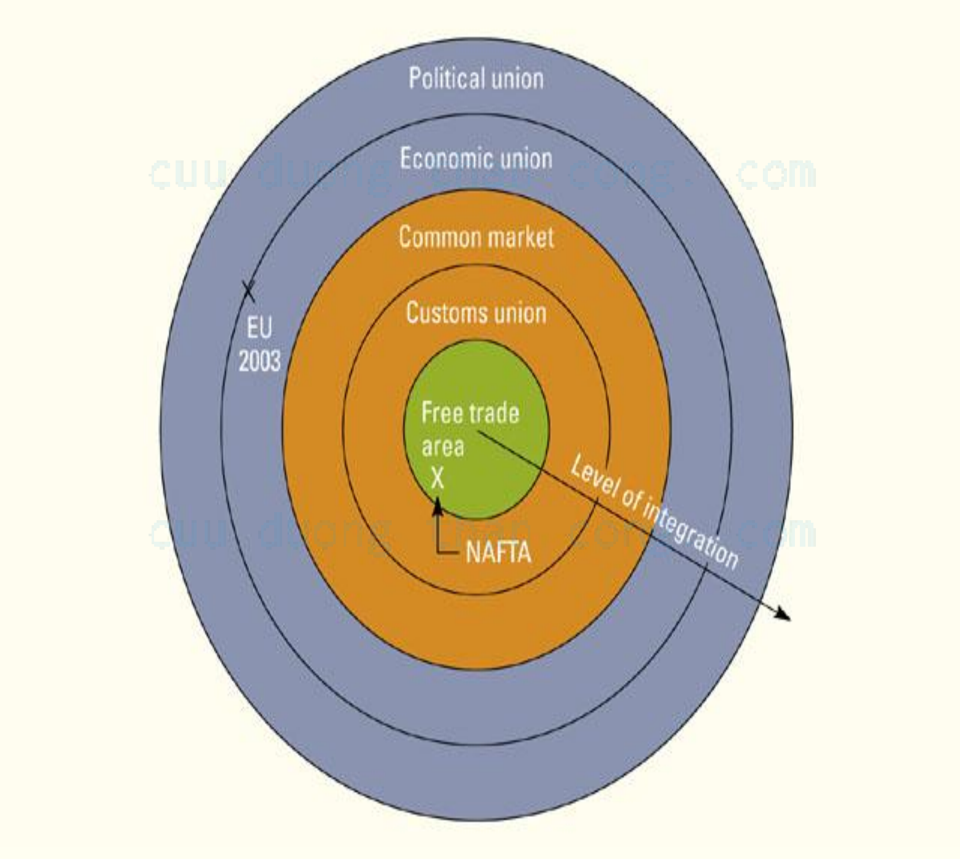
- There are five levels of economic integration

1. Free trade area - all barriers to the trade of goods and services among member countries are removed, but members determine their own trade policies with regard to nonmembers

- This is the most popular form of integration
- Examples include
  - the European Free Trade Association (between Norway, Iceland, Liechtenstein, and Switzerland)
  - the North American Free Trade Agreement (between the U.S., Canada, and Mexico)

Levels of Economic Integration

Levels of Economic Integration



Levels of Economic Integration

2. Customs union - eliminates trade barriers between member countries and adopts a common external trade policy

- Most countries that enter a customs union desire further integration in the future
- Examples include
  - the Andean Pact (between Bolivia, Columbia, Ecuador, Venezuela, and Peru)

Levels of Economic Integration

3. Common market - no barriers to trade between member countries, a common external trade policy, and the free movement of the factors of production

- This type of integration can be difficult to achieve and requires significant harmony among members in fiscal, monetary, and employment policies
- Examples include
  - MERCOSUR (between Brazil, Argentina, Paraguay, and Uruguay) hope to achieve this status

Levels of Economic Integration

4. Economic union - involves the free flow of products and factors of production between members, the adoption of a common external trade policy, and in addition, a common currency, harmonization of the member countries' tax rates, and a common monetary and fiscal policy

- This level of integration involves sacrificing a significant amount of national sovereignty
- Examples include
  - the European Union (EU)

Levels of Economic Integration

5. Political union - independent states are combined into a single union

- This requires that a central political apparatus coordinate economic, social, and foreign policy for member states
- The EU is headed toward at least partial political union, and the United States is an example of even closer political union

Classroom Performance System

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

a) Free trade area

b) Customs union

c) Common market

d) Economic union

Classroom Performance System

The European Union is an example of a(n)

a) Free trade area

b) Customs union

c) Common market

d) Economic union

The Case for Regional Integration

- There are both economic and political arguments supporting regional economic integration
- Generally, many groups within a country oppose the notion of economic integration

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

The 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

Regional Economic Integration in Europe

- Europe has two trade blocs
  - the European Union with 27 members
  - the European Free Trade Association with 4 members
- The European Union is expected to become a superpower of the same order as the United States

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

Evolution of the European Union

Member States of the European Union in 2008

Political Structure of the European Union

- 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 was born out of frustration among EC members that the community was not living up to its promise
- 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 Act prompted the restructuring of substantial sectors of European Industry

The Establishment of the Euro

- The Maastricht Treaty (1991) committed EU members to adopt a single currency, the euro
  - The euro is used by 15 of the 27 member states
  - This has 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
  - So far, Britain, Denmark and Sweden have opted out of the euro zone

The Establishment of the Euro

Question: What are the benefits of the euro?

- Firms and individuals should save by handling one currency, rather than many
- Consumers should find it easier to compare prices across Europe
- Producers should become more efficient as they reduce their production costs in order to maintain their profit margins
- The highly liquid pan-European capital market should get a strong boost
- The 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 in the euro zone implies that nations lose control over the 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)
  - So, countries may react very 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

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

Classroom Performance System

The ultimate decision making body of the European Union is the

a) Council of the European Union

b) European Parliament

c) Court of Justice

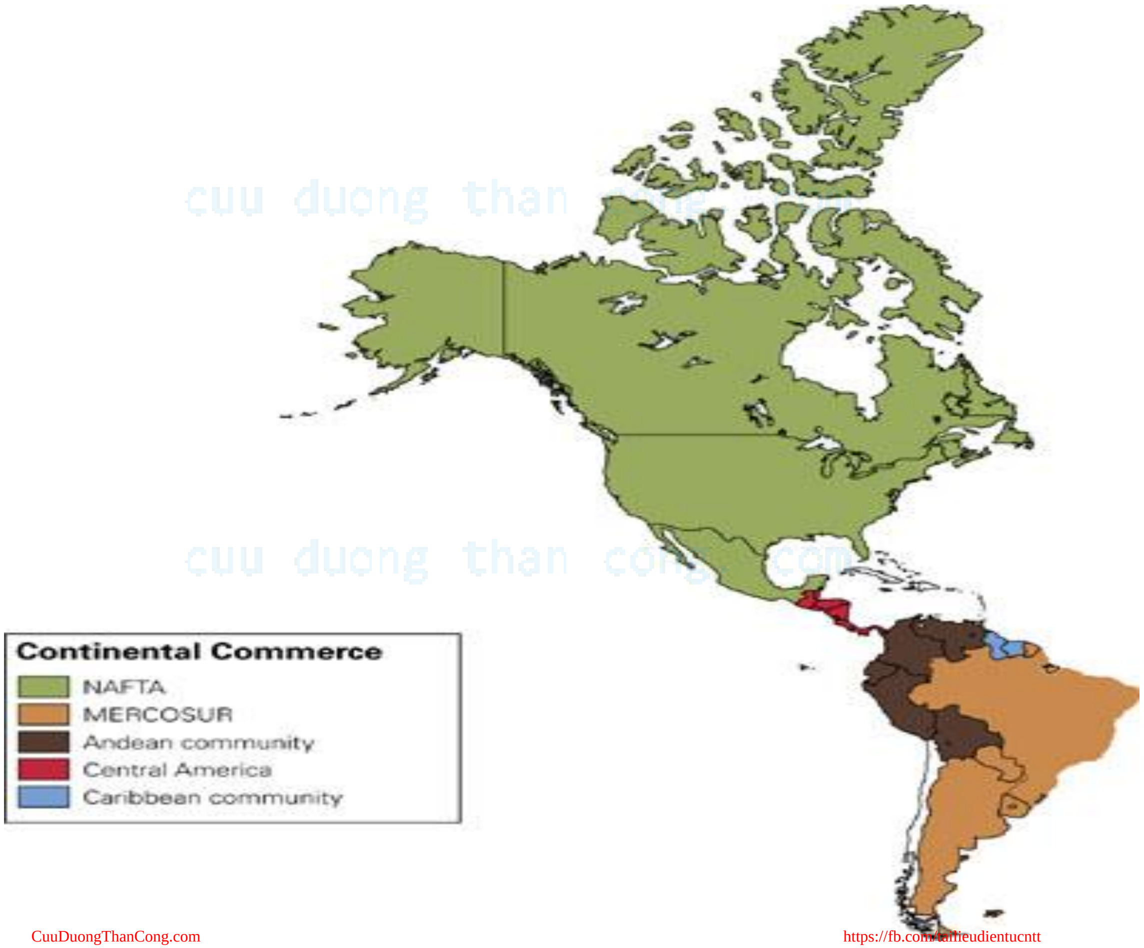
d) European Commission

Regional 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

Regional Economic Integration in the Americas

Regional Integration in the Americas



The North American Free Trade Agreement

- The North American Free Trade Agreement (NAFTA) between the U.S., Canada, and Mexico became law in 1994
- NAFTA
  - 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

The North American Free Trade Agreement

Question: What are the benefits of NAFTA?

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

The North American Free Trade Agreement

Question: What are the drawbacks of NAFTA?

- 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

The North American Free Trade Agreement

Question: How successful has NAFTA been?

- 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

The North American Free Trade Agreement

Question: Should NAFTA accept new members?

- 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

Classroom Performance System

Studies show that after its first decade

a) There was a small net gain of jobs in the U.S.

b) Exports from the U.S. failed to grow

c) NAFTA's overall impact has been significant

d) The U.S., Canada, and Mexico all experienced a decrease in productivity

The Andean Community

- The Andean Pact (formed in 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 originated in 1988 as 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

Central American Common Market, CAFTA and CARICOM

- Two other trade pacts in the Americas are

1. the Central American Trade Market
   - Current members are 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

Regional 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

Association of Southeast Asian Nations

- The Association of Southeast Asian Nations (ASEAN) was formed in 1967
- ASEAN currently includes Brunei, Indonesia, Malaysia, the Philippines, Singapore, Thailand, Vietnam, Myanmar, Laos, and Cambodia
- The goal of ASEAN is to foster freer trade between member countries and to achieve some cooperation in their industrial policies
- In 2003, an ASEAN Free Trade Area (AFTA) between the six original members of ASEAN came into full effect with a goal of reducing import tariffs among the older members
- Vietnam, Laos, and Myanmar have all joined AFTA more recently

Asia-Pacific Economic Cooperation

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

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?

- Thanks to regional economic integration, 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
- Because of the free movement of goods across borders, the harmonization of product standards, and the simplification of tax regimes, 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 in the EU intervenes and imposes conditions on companies proposing mergers and acquisitions

Critical Discussion Question

1. NAFTA has produced significant net benefits for the Canadian, Mexican, and U.S. economy. Discuss.

Critical Discussion Question

2. What are the economic and political arguments for regional economic integration? Given these arguments, why don't we see more substantial examples of integration in the world economy?

Critical Discussion Question

3. What effect is creation of a single market and a single currency within the EU likely to have on competition within the EU? Why?

Critical Discussion Question

4. Do you think it is correct for the European Commission to restrict mergers between American companies that do business in Europe? (For example, the European Commission vetoed the proposed merger between WorldCom and Sprint, both U.S. companies, and it carefully reviewed the merger between AOL and TimeWarner, again both U.S. companies.)

Critical Discussion Question

5. How should a U.S. firm that currently only exports to ASEAN countries respond to the creation of a single market in this regional grouping?

Critical Discussion Question

6. How should a firm that has self-sufficient production facilities to in several ASEAN countries respond to the creation of a single market? What are the constraints on its ability to respond in a manner that minimizes production costs?

Critical Discussion Question

7. After a promising start, in the last few years, MERCOSUR, the major Latin American trade agreement, has faltered and made little progress since 2000. What problems are hurting MERCOSUR? What can be done to solve these problems?

Critical Discussion Question

8. Would the establishment of a Free Trade Area of the Americas (FTAA) be good for the two most advanced economies of the hemisphere, the United States and Canada? How might the establishment of the FTAA impact the strategy of North American firms?

Critical Discussion Question

9. Reread the Management Focus case on the European Commission and Media Industry Mergers, then answer the following questions:

a) Given that both AOL and Time Warner were U.S. based companies, do you think the European Commission had a right to review and regulate their planned merger?

b) Were the concessions extracted by the European Commission from AOL and Time Warner reasonable? Whose interests was the Commission trying to protect?

c) What precedent do the actions of the European Commission in this case set? What are the implications for managers of foreign enterprises with substantial operations in Europe?