# International Business
7e

by Charles W.L. Hill

McGraw-Hill/Irwin

# 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
- Regional trade agreements are designed to promote free trade, but instead the world may be moving toward a situation in which a number of regional trade blocks compete against each other

# Levels Of Economic Integration

There are five levels of economic integration:

1. a free trade area eliminates all barriers to the trade of goods and services among member countries, but members determine their own trade policies for nonmembers

❖the European Free Trade Association (between Norway, Iceland, Liechtenstein, and Switzerland), and the North American Free Trade Agreement (between the U.S., Canada, and Mexico) are both free trade areas

# Levels Of Economic Integration

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

❖The Andean Pact (between Bolivia, Columbia, Ecuador and Peru) is an example of a customs union

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 (between Brazil, Argentina, Paraguay, and Uruguay) is aiming for common market status

# Levels Of 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 rates, and a common monetary and fiscal policy

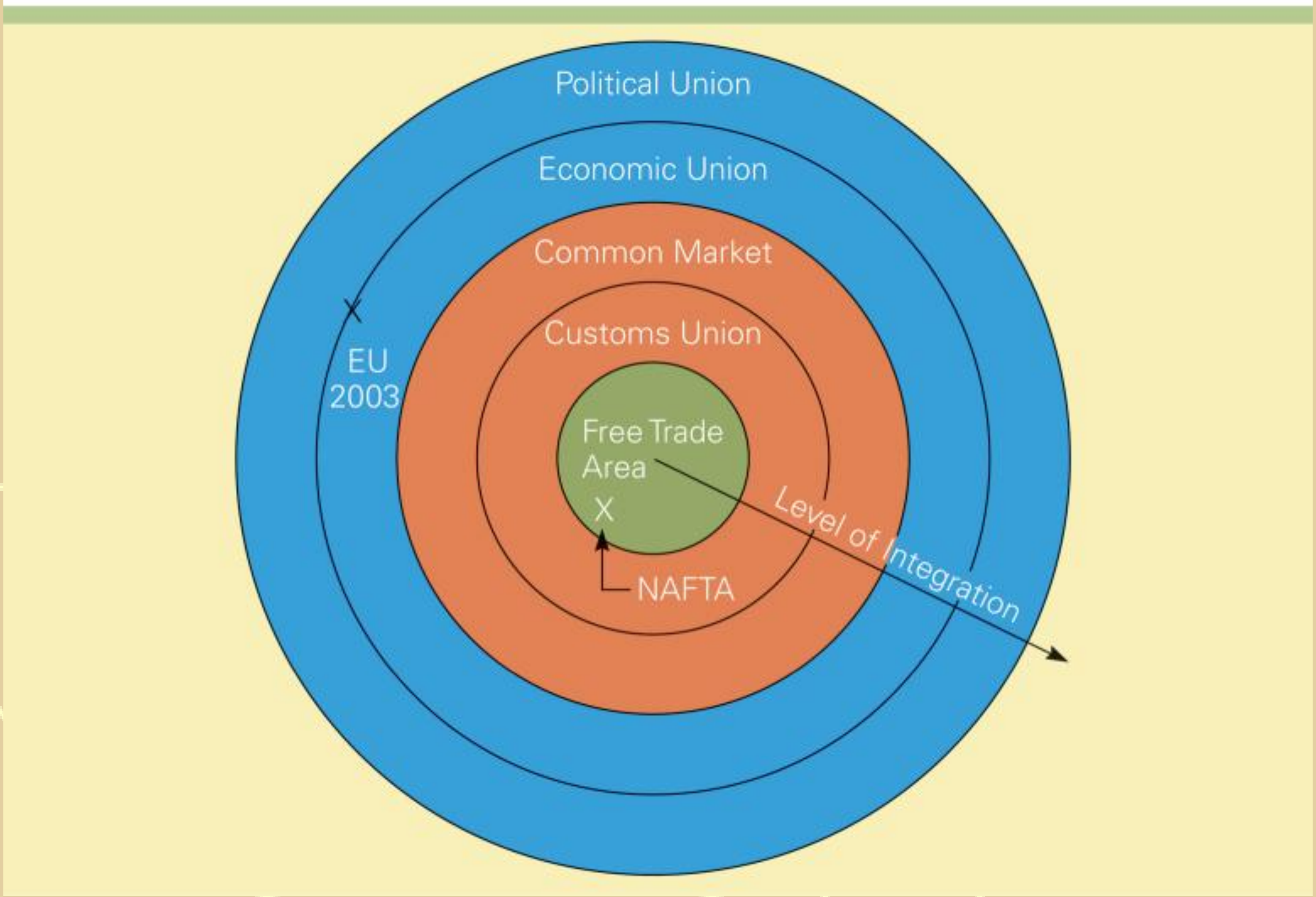
- The European Union (EU) is an imperfect economic union

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

# Levels Of Economic Integration

Figure 8.1



# Classroom Performance System

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

# Classroom Performance System

NAFTA is an example of a(n)

a) Free trade area

b) Customs union

c) Common market

d) Economic union

# The Economic Case For Regional Integration

- All countries gain from free trade and investment
- Regional economic integration is an attempt to exploit the gains from free trade and investment

# The Political Case For Regional Integration

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

# Impediments To 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

# The Case Against Regional Integration

- 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

# Classroom Performance System

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

# Regional Economic Integration In Europe

Europe has two trade blocs:

- The European Union (EU) with 27 members
- The European Free Trade Area (EFTA) with 4 members
- The EU is seen as the world's next economic and political superpower

# Regional Economic Integration In Europe

## Map 8.1: Member States of the European Union in 2007

# Evolution Of The European Union

- The EU was formed as a result of the devastation of two world wars on Western Europe and the desire for a lasting peace, and 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, which had the goal of removing barriers to trade in coal, iron, steel, and scrap metal formed in 1951
- The European Economic Community was formed in 1957 at the Treaty of Rome with the goal of becoming a common market

# Political Structure Of The European Union

There are five main institutions of the EU:

- ❖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

# Classroom Performance System

_______ 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

# Classroom Performance System

_______ is responsible for proposing EU legislation.

a) Council of the European Union

b) European Parliament

c) Court of Justice

d) European Commission

# The Single European Act

The Single European Act:

- was adopted by the EU in 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

# The Establishment Of The Euro

- The Maastricht Treaty committed the EU to adopt a single currency
- By adopting the euro, the EU has created the second largest currency zone in the world after that of the U.S. dollar
- The euro is used by 12 of the 25 member states
- For now, three EU countries, Britain, Denmark and Sweden, that are eligible to participate in the euro-zone, are opting out

# The Establishment Of The Euro

Benefits of the Euro:

- There are savings from having to handle one currency, rather than many
- A common currency will make it easier to compare prices across Europe
- European producers will be forced to look for ways to reduce their production costs in order to maintain their profit margins
- It should give a strong boost to the development of highly liquid pan-European capital market
- A pan-European euro denominated capital market will increase the range of investment options open both to individuals and institutions

# The Establishment Of The Euro

Costs of the Euro:

- ❖National authorities lose control over the monetary policy
- ❖The EU is not an optimal currency area (an area where similarities in the underlying structure if economic activities make it feasible to adopt a single currency and use a single exchange rate as an instrument of macro-economic policy)

# The Establishment Of The Euro

- Since its establishment January 1, 1999, the euro has had a volatile trading history with the U.S. dollar
- Initially, the euro fell in value relative to the dollar, but strengthened to a five year high of $1.30 in February 2006

# Enlargement Of The European Union

- Many countries have applied for EU membership
- Ten countries joined on May 1, 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 bring membership to 27 countries
- The new countries will not be able to adopt the euro until at least 2007, nor will there be free movement of labor between new and existing countries until then

# Regional 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

# The North American Free Trade Agreement

- The North American Free Trade Area (NAFTA) became law January 1, 1994
- NAFTA's participants are the United States, Canada, and Mexico

# The North American Free Trade Agreement

Map 8.2

# The North American Free Trade Agreement

NAFTA:

- abolished tariffs on 99 percent 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, provided such standards have a scientific base
- 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

NAFTA's supporters argue that:

- 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

Critics of NAFTA's argued that:

- 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

# The North American Free Trade Agreement

- Research indicates that NAFTA's early impact was subtle, and both advocates and detractors may have been guilty of exaggeration
- The agreement has helped to create the background for increased political stability in Mexico
- 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:
- was 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

# MERCOSUR

MERCOSUR:

- originated in 1988 as a free trade pact between Brazil and Argentina
- was expanded in 1990 to include Paraguay and Uruguay
- has been making progress on reducing trade barriers between member states
- may be diverting trade rather than creating trade, and local firms are investing in industries that are not competitive on a worldwide basis

# Central American Common Market And CARICOM

There are two other trade pacts in the Americas:

- the Central American Trade Market (CAFTA) – to lower trade barriers between the U.S. and members
- CARICOM – 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

# 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
- If the FTAA is established, it will have major implications for cross-border trade and investment flows within the hemisphere
- The FTAA would create a free trade area of nearly 800 million people

# Regional Economic Integration Elsewhere

- Several efforts have been made to integrate in Asia and Africa
- One of the most successful is the Association of Southeast Asian Nations (ASEAN)

# Association Of Southeast Asian Nations

The Association of Southeast Asian Nations (ASEAN):

- was formed in 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

# Association Of Southeast Asian Nations

## Map 8.3

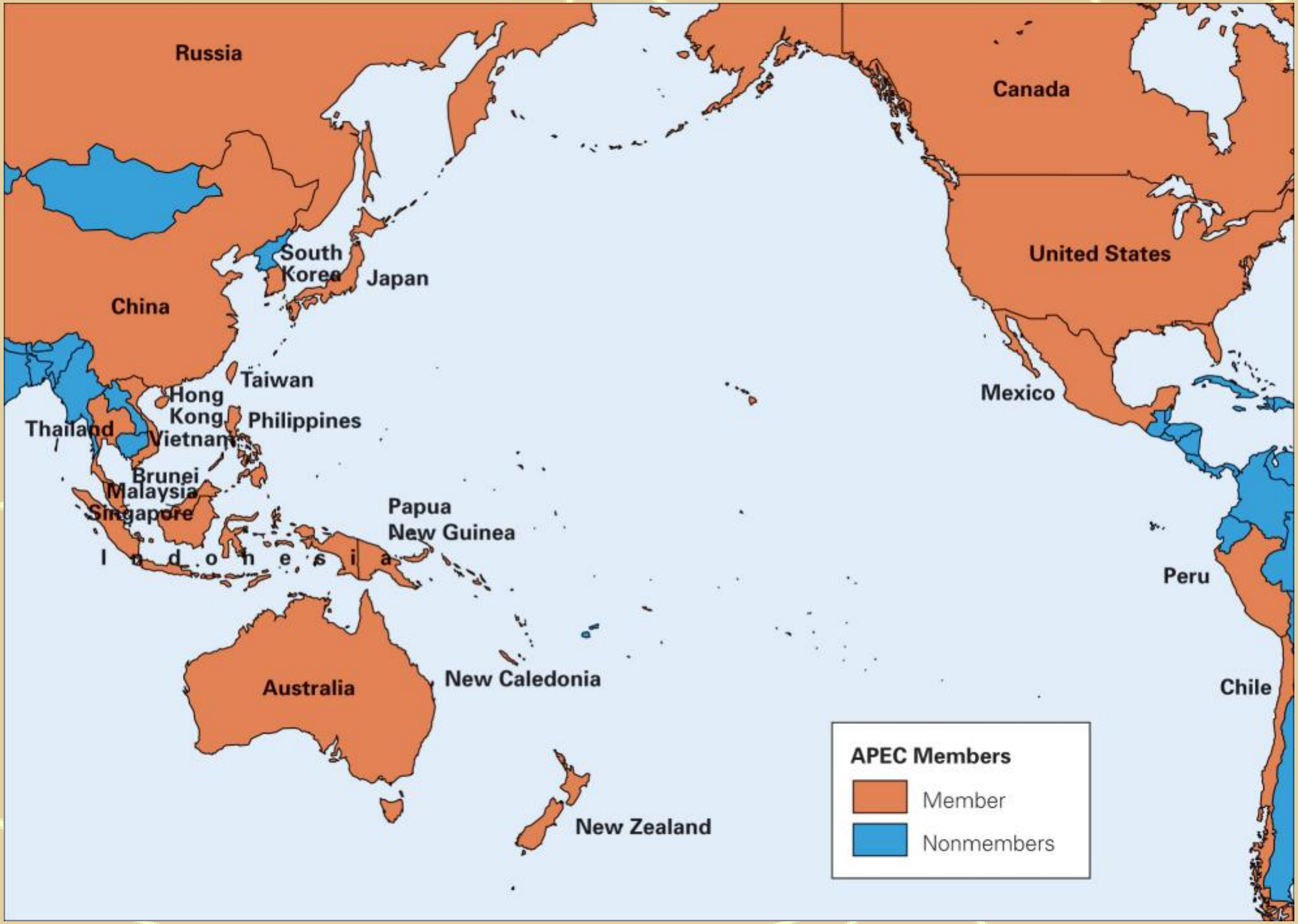
# Asia-Pacific Economic Cooperation

The Asia-Pacific Economic Cooperation (APEC):

- currently has 21 members including the United States, Japan, and China
- wants to increase multilateral cooperation in view of the economic rise of the Pacific nations and the growing interdependence within the region

# Asia-Pacific Economic Cooperation

Map 8.4



# Regional Trade Blocs In Africa

- Progress toward the establishment of meaningful trade blocs in Africa has been slow
- Many countries are members of more than one of the nine dormant blocs in the region
- Kenya, Uganda, and Tanzania committed to re-launching the East African Community (EAC) in 2001, however so far, the effort appears futile

# Implications For Managers

- The EU and NAFTA currently have the most immediate implications for business

# Opportunities

Regional economic integration:

- opens new markets
- makes it possible for firms to realize potentially enormous cost economies by centralizing production in those locations where the mix of factor costs and skills is optimal

# Threats

- ❖Within each grouping, the business environment becomes competitive
- ❖EU companies are becoming more capable
- ❖There is a risk of being shut out of the single market by the creation of a “trade fortress”
- ❖The EU is becoming more willing to intervene and impose conditions on companies proposing mergers and acquisitions which could limit the ability of firms to follow the strategy of their choice

# Classroom Performance System

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