25 Economic integration

By the end of this chapter, you should be able to:

- distinguish between bilateral and multilateral trade agreements
- define, explain, and give examples of different types of trading blocs
- discuss advantages and disadvantages of a monetary union for its members
- **HL** define, explain, illustrate, and give examples of trade creation
- **HL** define, explain, illustrate, and give examples of trade diversion.

Economic integration describes a process whereby countries coordinate and link their economic policies. As the degree of economic integration increases, the trade barriers between countries decrease and their fiscal and monetary policies are more closely harmonized.

A bilateral trade agreement is an agreement relating to trade between two countries. The aim is usually to reduce or remove tariffs and/or quotas that have been placed on items traded between the two countries.

A multilateral trade agreement is an agreement relating to trade between multiple countries. It also usually aims to reduce or remove tariffs and/or quotas that have been placed on traded items, but the agreement in this case applies to all of the multiple countries involved.

Trading blocs

A trading bloc is defined as a group of countries that join together in some form of agreement in order to increase trade between themselves and/or to gain economic benefits from cooperation on some level. This coming together is economic integration. The Hungarian economist Béla Balassa identified six stages of economic integration:

1 *Preferential trading areas:* A preferential trading area (PTA) is a trading bloc that gives preferential access to certain products from certain countries. This is usually carried out by reducing, but not eliminating, tariffs.

   An example of a PTA is the one between the EU and the African, Caribbean, and Pacific Group of States (ACP). This is an agreement between the EU and 78 countries in the ACP. Many of the countries were former colonies of EU members. It enables the EU to guarantee regular supplies of raw materials and the ACP countries to gain tariff preferences and access to special funds that are used to try to achieve price stability in agricultural and mining markets.

   Since 2008 the arrangement has been a "reciprocal trade agreement". This means that the EU provides duty-free access to its markets for exports from the ACP countries and also receives duty-free access for its own exports to the ACP countries.

However, it is agreed that not all of the ACP countries have to open up to EU exports. The least-developed countries in the ACP group may opt for other arrangements.

2 *Free trade areas:* A free trade area is an agreement made between countries, where the countries agree to trade freely among themselves, but are able to trade with countries outside of the free trade area in whatever way they wish. This situation is shown in Figure 25.1.

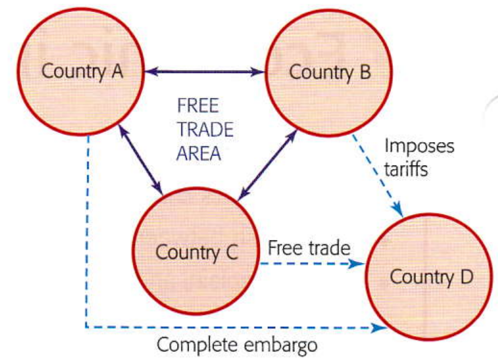

Figure 25.1 A free trade area

In this hypothetical case, countries A, B, and C have signed a free trade agreement and are now trading freely among themselves. However, under the agreement, each country may trade with any other country in any way it sees fit. Thus country A has political grievances with country D and so has placed a complete embargo on foreign trade. Country B protects its economy from country D by placing tariffs on a number of its imports. Country C has good relationships with country D and trades freely with it.

An example of a free trade area is the North American Free Trade Area (NAFTA), which comprises the USA, Canada, and Mexico. NAFTA was established in January 1994 and, following a final tariff reduction between Canada and Mexico in January 2003, virtually all trade in the NAFTA region is tariff-free. Over 75% of Canadian total exports now go to the USA, and Mexico's share of the US import market has grown from approximately 7% in pre-NAFTA times to approximately 12% today.

Other examples of free trade agreements are the European Free Trade Association (Iceland, Norway, Switzerland, and Liechtenstein), and the South Asia Free Trade Agreement (India, Pakistan, Nepal, Sri Lanka, Bangladesh, Bhutan, and the Maldives).

3 *Customs unions:* A customs union is an agreement made between countries, where the countries agree to trade freely among themselves, and they also agree to adopt common external barriers against any country attempting to import into the customs union. This situation is shown in Figure 25.2.

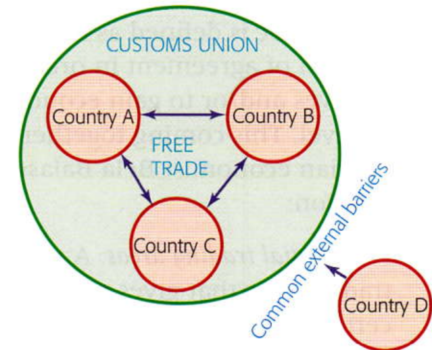

Figure 25.2 A customs union

Countries A, B, and C have joined in a customs union and are trading freely with each other. If country D wishes to export goods to the customs union, the goods will be treated in the same way, no matter which country the goods enter. If the customs union has agreed to place tariffs on the products of country D, then those tariffs will be imposed, no matter what the point of entry to the customs union.

All common markets and economic and monetary unions are also customs unions, thus the EU has a customs union. Other examples would be the Switzerland–Liechtenstein customs union; the East African Community, which is a customs union comprising Kenya, Uganda, and Tanzania; and Mercosur, which is a customs union between Brazil, Argentina, Uruguay, Paraguay, and Venezuela.

4 *Common markets:* A common market is a customs union with common policies on product regulation, and free movement of goods, services, capital, and labour.

The best-known example of a common market is the EU. The CARICOM Single Market and Economy (CSME) is another example, which is expected to be fully implemented with harmonisation of economic policy and, possibly, a single currency. The current members are Barbados, Belize, Guyana, Jamaica, Suriname, Trinidad and Tobago, Antigua and Barbuda, Dominica, Grenada, St Kitts and Nevis, St Lucia, and St Vincent and the Grenadines. Montserrat is also expected to join.

5 *Economic and monetary union:* An economic and monetary union is a common market with a common currency and a common central bank. The best example of an economic and monetary union is the eurozone, which includes the member countries of the EU that have adopted the euro as their currency and have the European Central Bank (ECB) as their central bank. In 2010, the members consisted of Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain.

There are a number of advantages of a monetary union for the member countries.

- Exchange rate fluctuations that used to exist between countries will disappear with a common currency and this should eliminate exchange rate uncertainty between the countries involved, which should increase cross-border investment and trade.
- A currency which has the enhanced credibility of being used in a large currency zone should be more stable against speculation than the individual currencies were.
- Business confidence in the member countries tends to improve as there is less of a perceived risk involved in trading among the countries. This in turn should lead to both internal growth and trade growth.
- Transaction costs are eliminated within the monetary union. When countries have different currencies there is a charge when currencies are exchanged, but this will not happen with the existence of a single currency.
- A common currency makes price differences more obvious between countries and should, over time, lead to prices equalizing across borders.

There are also a number of disadvantages of a monetary union for the member countries.

- When countries enter a monetary union, interest rates are decided by the central bank. This means that individual countries are no longer free to set their own interest rates and so the tool of monetary policy (see Chapter 14) is no longer an option to influence the inflation rate, the unemployment rate, and the rate of economic growth. This is especially damaging if one country in the union is experiencing an economic situation that is not being experienced by the others. For example, if one country was experiencing high inflation due to strong consumer demand, which other countries were not, it might want to increase interest rates to reduce the demand. However, this would not happen and other measures would have to be found.

- While a common central bank is seen as a prerequisite of monetary union, many argue that without fiscal integration, in the form of a common treasury, harmonized tax rates, and a common budget, a monetary union will be weak and vulnerable, since some countries will be more fiscally irresponsible than others and this may threaten the stability of the union.
- Individual countries are not able to alter their own exchange rates in order to affect the international competitiveness of their exports or the costs of their imports.
- The initial costs of converting the individual currencies into one currency are very large. The costs include such things as taking the old currencies off the market, printing and distributing the new currency, converting databases and software, rewriting all price lists and invoice systems, re pricing all goods and services in the economy, and recalibrating all machinery that takes coins and notes, such as parking meters and vending machines.

It is almost impossible to weigh up the advantages and disadvantages of membership of a monetary union. The situation will be very different in different cases. Perhaps it is best to try to determine when membership would be most beneficial and when it would make the least difference.

In a situation where there were large fluctuations between the exchange rates of the countries involved, where the union is going to create a single currency with a significant proportion of the world's foreign currency market and where business confidence will be strongly boosted between member countries, then it is likely that membership of a common currency will be beneficial to the individual countries.

If countries are in a situation where fluctuations in exchange rates are minimal, where the common currency would not be significant on the world market, so would still be susceptible to speculation, and where business confidence is already high, then the advantages of joining a single currency would be few and the disadvantages may well be greater.

6 *Complete economic integration:* This would be the final stage of economic integration, at which point the individual countries involved would have no control of economic policy, full monetary union, and complete harmonisation of fiscal policy. This is what the Eurozone is moving towards.

DID YOU **KNOW?**

Following the global financial crisis that started in 2007, the eurozone first entered recession in the third quarter of 2008. (Remember that a recession occurs when there are two or more consecutive quarters of negative economic growth.) Heads of state and government of the eurozone countries, the Euro Group, met in Paris in October 2008 to develop an economic plan to achieve recovery. They agreed a bank rescue plan and approximately €500 billion was injected into the banks in June 2009 by the ECB.

Although people were afraid that the impact of such a large recession might lead to a breaking up of the eurozone, the euro's position actually got stronger as 2009 went on.

However, in the early part of 2010, fears of domestic debt crises developed relating to eurozone countries, such as Greece, Spain, Portugal, Italy, and Ireland. Government fiscal spending in order to overcome internal lack of consumption was thought to be irresponsible and much too high.

This led to a crisis of confidence as well as attacks by speculators on Greece, and therefore the euro. The euro suffered a substantial fall in its exchange rate value. The attack by speculators was seen by some, especially the Greek government, as an attack on the eurozone itself, targeting Greece as a weak link. The EU adopted a plan to aid Greek recovery and a €30 billion bailout for Greece was formulated in April 2010. However, the crisis has led to a renewed discussion of the importance of fiscal integration as a means of eliminating a major weakness of the eurozone. The need for a central treasury (or ministry of finance), a central budget, and greater tax harmonization is considered by some to be of great importance if the euro is to gain long-term stability. Fiscal coordination is essential.

As we write, there are rumours that the French president has threatened to pull France out of the euro; that Germany will have to leave the euro; that Greece will be forced to leave in order for the euro to survive; and that, if Greece leaves the euro, then Spain, Portugal, and Italy will also leave.

A number of leading economists have suggested that a smaller eurozone could be the only way to reverse the fall of the euro and a poll conducted among 25 leading City of London economists came out with the majority believing that the euro would not exist in five years' time. This is all part of the joy of economics: its relevance and unpredictability. Watch this space!

An evaluation of trading blocs

The extent of the advantages and disadvantages of trading blocs clearly depends on the degree of integration. In purely economics terms, the benefits of being a member of a trading bloc are similar to those of free trade. These include a greater size of market with the potential for larger export markets, increased competition leading to greater efficiency, more choice, and lower prices for consumers. The consequences may not be even, as some domestic producers are likely to gain from the larger market while others may find themselves unable to compete.

There may be a further stimulus for investment due to the larger market size, and foreign investment might be attracted from outside the bloc as a way of getting a foot in the door of the larger market.

There is also an argument that, along with the economic gains, a trading bloc will foster greater political stability and cooperation. It is also possible that trade negotiations may be easier in a world made up of a number of large trading blocs, rather than among 149 sovereign states.

However, by their very nature, trading blocs favour increased trade among members, but enact discriminatory policies against non-members, and this can be damaging to the achievements of the multilateral trading negotiations of the WTO. There is concern that the breakdown in WTO talks in Geneva in July 2006 will lead to an increase in the number of individual trade negotiations. These may undermine the international trade rules and limit the potential gains to trade achievable with more liberalized world trade. This may not be as much of a problem for large economies as it might be for small or poor economies that have little bargaining power.

Student workpoint 25.1

Be knowledgeable

Make a table to summarize the information about trading blocs. Include the name of each of the six types of economic integration, a definition, and examples. The table should illustrate how economic integration increases at each stage.

DID YOU KNOW?

Brazil, Argentina, Uruguay, and Paraguay were the original members of Mercosur, otherwise known as the Common Market of the South. In 2006, Venzuela joined the customs union. Mercosur covers a land area of 12 million square kilometres, which is more than four times the size of Europe. It represents a potential market of 270 million people and has a joint GDP of US$ 2.4 trillion, making it the world's fourth largest trading bloc after the EU, NAFTA and the Association of South East Asian Nations (ASEAN). While the Mercosur countries have often been united on issues such as their opposition to subsidies that rich countries give their farmers, there has been criticism of the inability of the union to move forwards in integrating the union's economies. This has been delayed by trade battles among members, particularly between Brazil and Argentina.

Mercosur is not the only trading bloc where disputes exist among members. For example, there has been a long-standing dispute between Canada and the USA over the timber and lumber trade between the two NAFTA members. Fierce debates, intensive lobbying, tariffs, and retaliatory tariffs are some of the signs of the discord.

Thus, membership of a trading bloc is a signal that members wish to liberalize trade, but is no guarantee that free trade will take place.

Student workpoint 25.2

Be an inquirer

1 Choose one trading bloc to research. Make an annotated time line to show the steps involved in its establishment and evolution. Be sure to note any significant achievements and/or setbacks.

2 Pick one country in the bloc and evaluate how it has been affected by membership of the zone.

HL

Trade creation and trade diversion

When a country joins a customs union there are advantages and disadvantages. Two possible outcomes need to be considered here.

Trade creation

Trade creation occurs when the entry of a country into a customs union leads to the production of a good or service transferring from a high-cost producer to a low-cost producer. This is an advantage of greater economic integration. The concept is best explained by an example.

Let us assume that when the UK joined the EU in 1973, it had a comparative advantage over France, a member of the EU at that time, in the production of lawnmowers. However, as a non-member of the EU, the EU had placed a tariff on UK lawnmowers. The situation is shown in Figure 25.3.

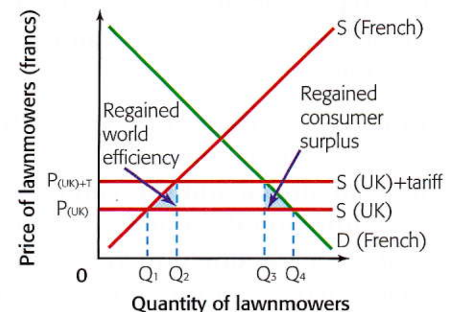

Figure 25.3 Trade creation

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With the tariff on UK lawnmowers in place, the French would produce OQ_2 lawnmowers themselves and would import Q_2 Q_3 lawnmowers from the UK. On entering the EU, the tariff on UK lawnmowers is relaxed and the UK can now make full use of its comparative advantage. With the tariff gone, French production falls to OQ_1 and imports rise to Q_1 Q_4. There are Q_3 Q_4 more lawnmowers bought and thus trade has been created. In addition, the extra demand means that there is an increase in consumer surplus, shown by the shaded triangle.

There is also a movement from high-cost to low-cost producers, since Q_1 Q_2 lawnmowers, which were being made by relatively inefficient French producers, are now being made by more efficient UK producers. Although the French lawnmower producers may have lost out, there has been a world welfare gain, because fewer resources are being used to produce these lawnmowers.

It should be remembered that this ought to be a two-way process. It is highly likely that, with free trade, there will also be French products that the UK will now buy more of because the French have the comparative advantage, for example wine.

Trade diversion

Trade diversion occurs when the entry of a country into a customs union leads to the production of a good or service transferring from a low-cost producer to a high-cost producer. This is a disadvantage of greater economic integration. Once again, the concept is best explained by an example.

Let us assume that when the UK joined the EU in 1973, it had been producing textiles itself and importing textiles from Thailand, which had a comparative advantage in the product. However, once the UK joined the EU, it had to place a tariff on Thai textiles,* because the EU already had one in place. The situation is shown in Figure 25.4.

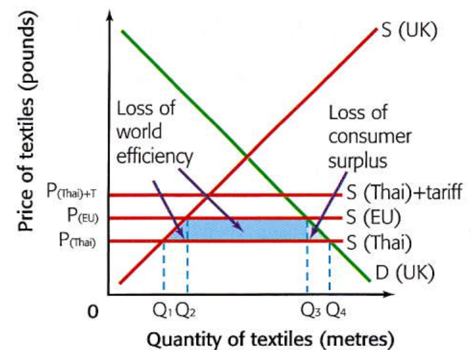

Figure 25.4 Trade diversion

Before the entry into the EU, the UK would produce $0Q_1$ metres of textiles domestically and would import Q_1Q_4 metres of textiles from Thailand. On entering the EU, the UK is forced to impose the same tariff on Thai textiles as the other EU countries. With the tariff in place, Thai textiles become more expensive than textiles produced in the EU. Because of this, the UK will now produce $0Q_2$ metres of textiles itself and will import Q_2Q_3 metres of textiles from the EU. There will be an overall fall in the quantity demanded of textiles of Q_3Q_4 metres and so a loss of consumer surplus shown by the shaded triangle.

There is also a movement from low-cost to high-cost producers, since Q_1Q_2 metres of textiles that were being produced by relatively efficient Thai producers, are now being produced by less efficient UK producers. Although the UK producers may have gained, there has been a world welfare loss, because more resources are being used to produce these textiles.

To make matters worse, the production of Q_2Q_3 metres of textiles has transferred from efficient Thai producers to relatively inefficient EU producers, so the trade diversion is even greater, as is the loss of world welfare. This represents a misallocation of the world's resources and represents a disadvantage of economic integration.

END OF CHAPTER REVIEW QUESTIONS

1 Using a diagram, explain the difference between a free trade area and a customs union. Use real world examples.
2 Discuss the likely effects of membership of a customs union. Be sure to use a real world example.
3 Evaluate the consequences of membership of a monetary union. Be sure to use a real world example.

You be the journalist

Headline: Polls show that a small majority favours the government's decision to join the regional customs union

Economics concept: Economic integration

Diagram(s): Higher level students—trade creation

Hints: You could pick any country with which you are familiar and explain why certain groups within the country would favour membership of a customs union. If space allows, consider why some groups (probably some producers) would be against it.