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**EE451**

**Chapter 9: Economic Integration**

# Definitions

- Economic Integration
  - Formal regional economic arrangements
  - Each participating country enjoys benefits from removal of trade restrictions on the movement of goods and services between members.
  - 4 types

# 4 Types of EC Integration

- FTA: Free-trade area
  - Members of the group remove tariffs on each other's product,
  - Each member retains its independence in establishing trading policies with nonmembers.
  - Concern: Rules of Origin

# 4 Types of EC Integration

- Customs Union
  - All tariffs are removed between members.
  - The group adopts a common external commercial policy, incl common external tariff (CET) toward nonmembers.
  - The group acts as one body in the negotiation with nonmembers.
  - Concerns: members give up independence in setting tariff rates.
  - Example: Benelux (1947)

# 4 Types of EC Integration

- Common Market
  - All tariffs are removed between members.
  - A common external policy is adopted for nonmembers.
  - All barriers to factor movements among members are removed. → free movement of labour and capital
  - Concerns: members give up sovereignty in immigration and capital flows.
  - Example: European Union (EU)

# 4 Types of EC Integration

- Economic Union
  - Common Market
  - Plus the unification of economic institutions and the coordination of economic policy throughout all member countries.
  - Becomes a monetary union when the group adopts a common currency.
  - Concern: members give up autonomy in monetary policy.

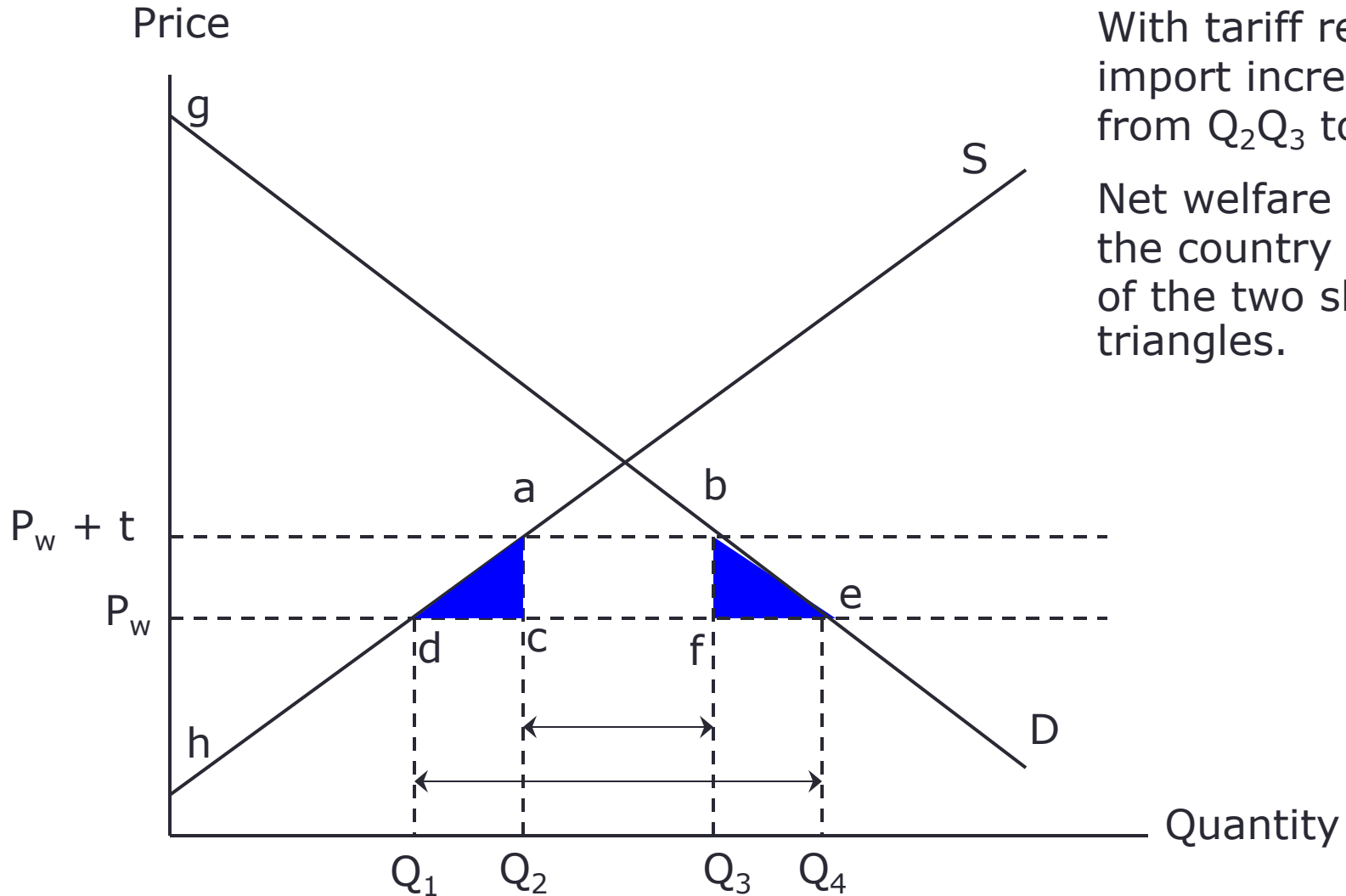
# Static Effects

- Economic integration can shift the pattern of trade between members and nonmembers.
- Trade creation:
  - Shift in product origin from a domestic producer whose resource costs are higher to a member producer whose resource costs are lower.
  - Movement toward the free-trade allocation of resources.
  - Beneficial for welfare.

# Static Effects

- Trade diversion:
  - Shift in product origin from a nonmember producer whose resource costs are lower to a member producer whose resource costs are higher.
  - Movement away the free-trade allocation of resources.
  - Could reduce welfare.
- The net effect is ambiguous.

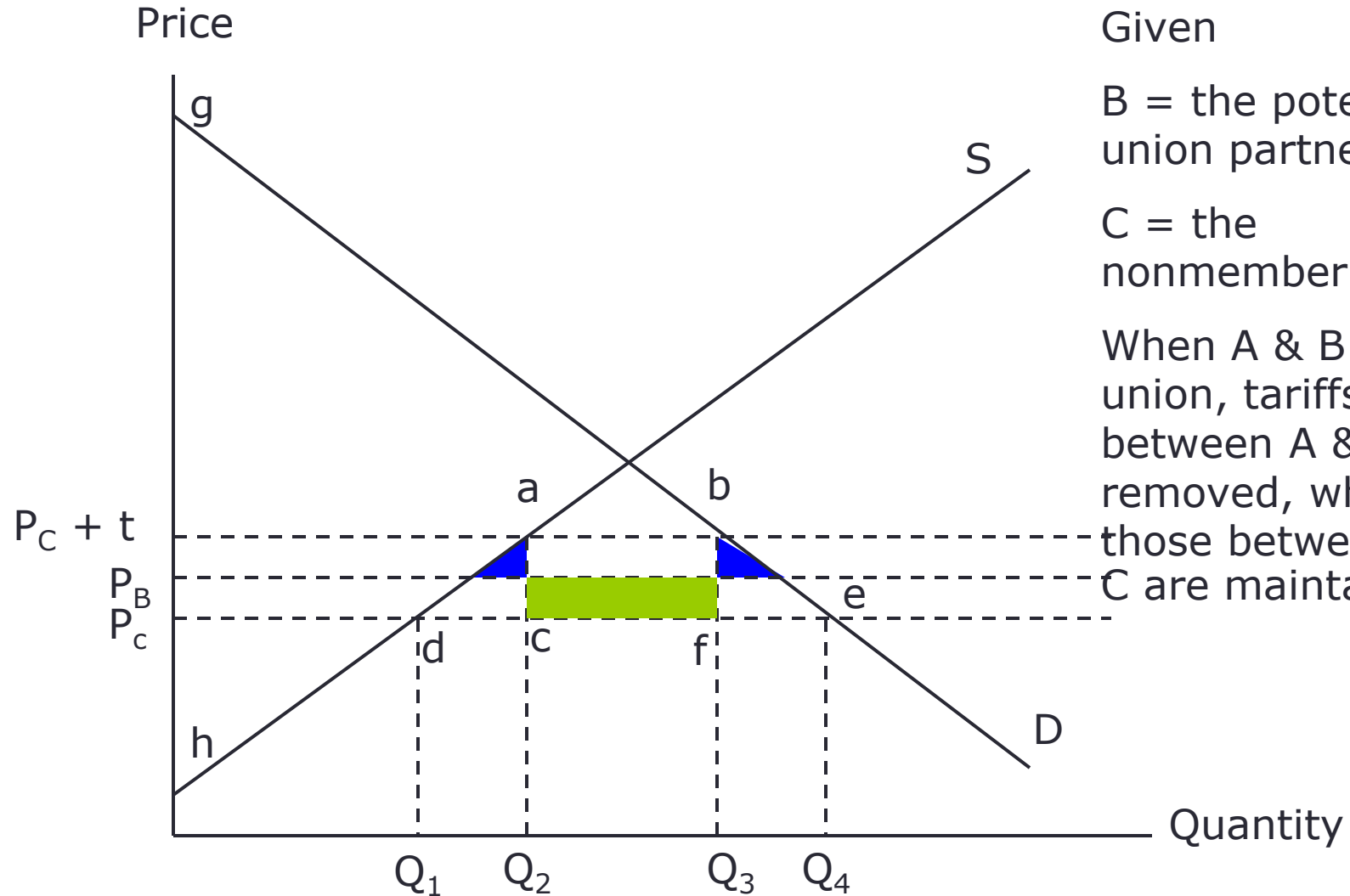
# Graphical Illustration



With tariff removed, import increases from  $Q_2Q_3$  to  $Q_1Q_4$ .

Net welfare gain for the country consists of the two shaded triangles.

# Graphical Illustration



Given

B = the potential union partner;

C = the nonmember

When A & B form a union, tariffs between A & B are removed, while those between A & C are maintained.

# Trade Diversion in General Equilibrium

# Four General Rules

- (I) The more closely the price in the partner country approaches the low-cost world price, the more likely the effect of integration on the market will be positive.
- (II) The effect of the integration is more likely to be positive the higher the initial tariff rate.
  - At the extreme, if the tariffs were prohibitive, there would be no welfare loss from trade diversion.

# Four General Rules

- (III) The more elastic the supply and the demand curves, the greater the quantity response by both consumers and producers; thus the larger two triangle areas.
- (IV) Integration is more likely to be beneficial when there is a greater number of participants.

# Empirical Evidence

- Balassa (1974) utilised the concept of the *ex post* income elasticity of import demand (YEM)
- After integration,
  - A rise in the YEM for imports from partner countries → gross trade creation
  - A fall in the YEM for imports from the outside group → trade diversion
  - A rise in the YEM for imports from all sources (both intra and outside the group) → trade creation proper.

# Empirical Evidence: EC Balassa (1974)

Intra-area imports	Pre (1953-59)	Post (1959-70)
Chemicals	3.0	3.7
Fuels	1.0	1.6
Machinery	2.1	2.8
Nontropical food	2.5	2.5
Raw materials	1.9	1.8
Transport equipments	2.9	3.5

# Empirical Evidence: EC Balassa (1974)

Outside-area imports	Pre (1953-59)	Post (1959-70)
Chemicals	3.0	2.6
Fuels	1.8	2.1
Machinery	0.9	2.4
Nontropical food	1.4	1.0
Raw materials	1.0	1.0
Transport equipments	2.2	2.5

# Empirical Evidence: EC Balassa (1974)

Total imports	Pre (1953-59)	Post (1959-70)
Chemicals	3.0	3.2
Fuels	1.6	2.0
Machinery	1.5	2.6
Nontropical food	1.7	1.5
Raw materials	1.1	1.1
Transport equipments	2.6	3.2

# Dynamic Impacts

- Increased economic growth
- Change in tastes

## The more beneficial effects will take place ...

- The greater the ease of switching from a higher-cost domestic source to a lower-cost member source.
- The greater the pre-union per-unit cost differences between the two sources.
- The greater the scope of experiencing economies of scale and attracting FDI.
- If transportation costs are considered, the closer the member countries are geographically, the more likely there will be static and dynamic gains from integration.

# Why EC integration has failed !

- Despite the fact that trade creation outweighs trade diversion, two concerns can contribute to failure of economic integration:
  - Distribution of benefits between members
  - The issue of national sovereignty