EE451

International Trade Theory and Policy

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 on 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.

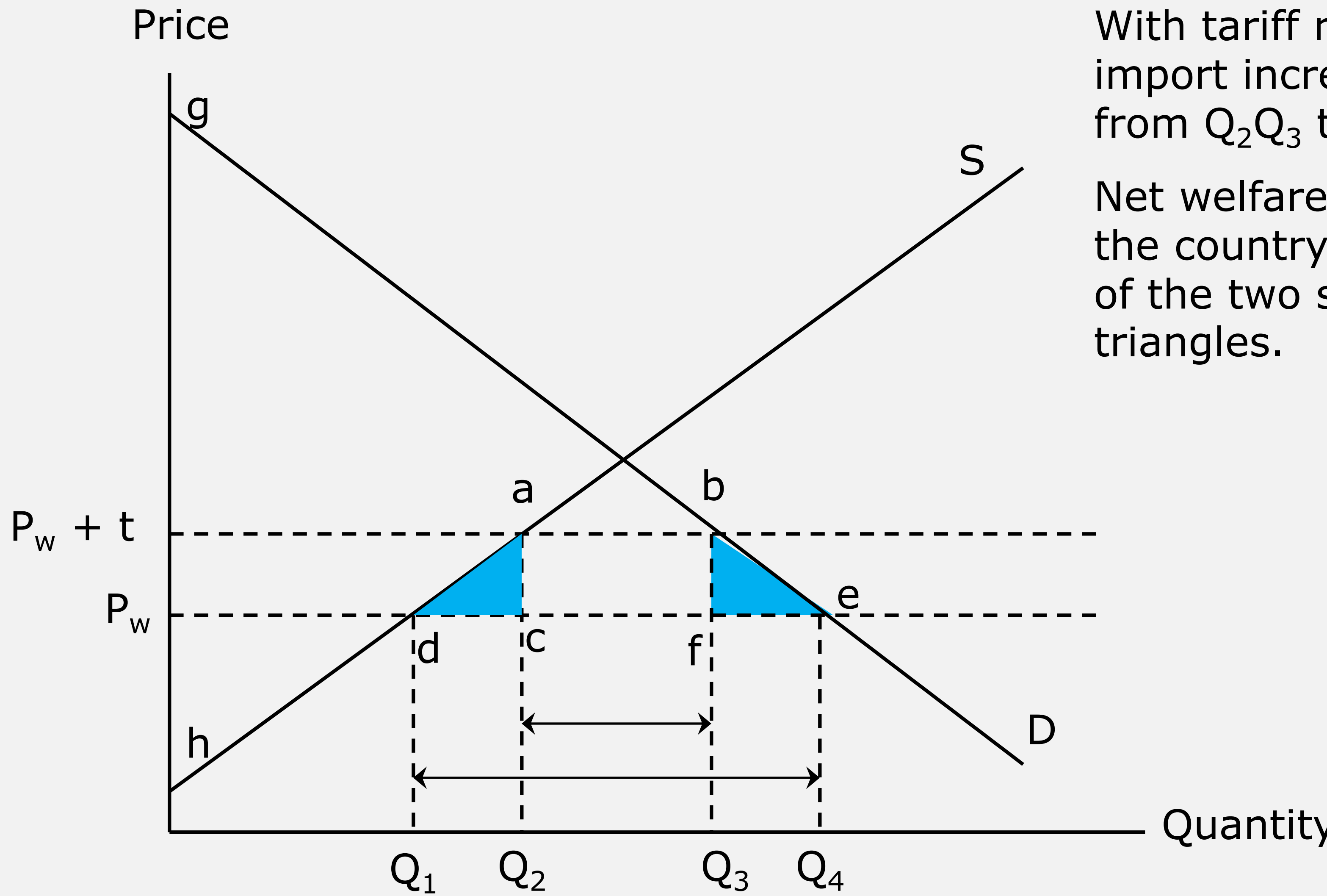
EXAMPLES OF EC INTEGRATION UNITS

- Andean Community of Nations (CAN)
  - Bolivia, Colombia, Ecuador, Peru, Venezuela
- Arab Cooperation Council (ACC)
  - Egypt, Iraq, Jordan, Yemen
- Benelux Economic Union (Benelux)
  - Belgium, Luxembourg, Netherlands
- European Free Trade Association (EFTA)
  - Iceland, Liechtenstein, Norway, Switzerland
- European Union (EU)
  - Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, United Kingdom + 10 new members (2004): Cyprus, Malta, Estonia, Latvia, Lithuania, the Czech Republic, Hungary, Poland, Slovakia, and Slovenia
- North American Free Trade Agreement (NAFTA)
  - Canada, Mexico, United States

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.
- 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.

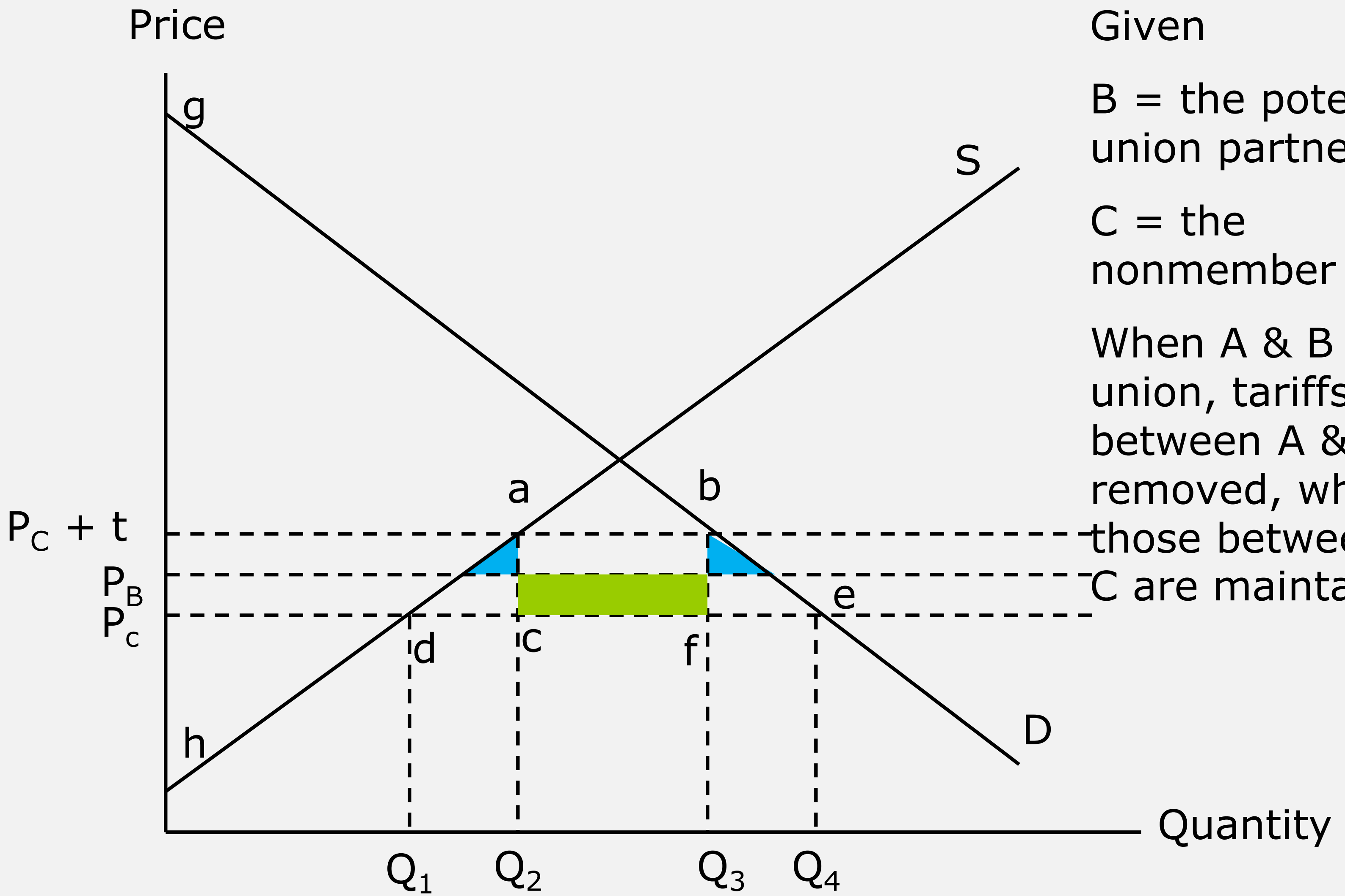
GRAPHICAL ILLUSTRATION



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.

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.
- (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 OF EUROPEAN COMMUNITY BALASSA (1974)

income elasticity of import demand	Intra-area imports		Outside-area imports		Total imports	
	Pre	Post	Pre	Post	Pre	Post
Chemicals	3.0	3.7	3.0	2.6	3.0	3.2
Fuels	1.0	1.6	1.8	2.1	1.6	2.0
Machinery	2.1	2.8	0.9	2.4	1.5	2.6
Nontropical food	2.5	2.5	1.4	1.0	1.7	1.5
Raw materials	1.9	1.8	1.0	1.0	1.1	1.1
Transport equipments	2.9	3.5	2.2	2.5	2.6	3.2

Pre (1953-59)

Post (1959-70)

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

- An example of BREXIT