Economic Integration

Economic integration

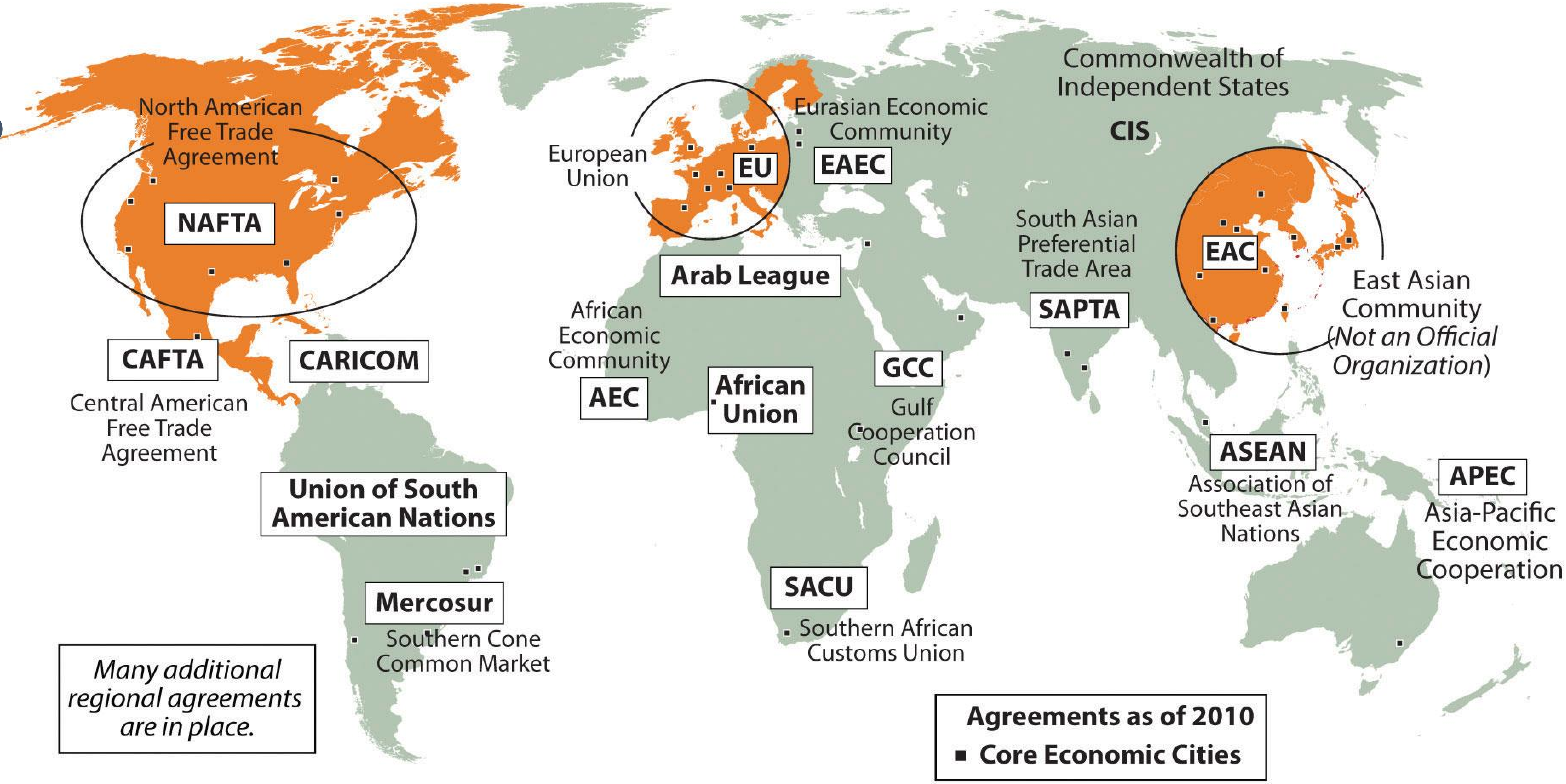
Economic Integration refers to economic interdependence between countries, usually achieved by agreement between countries to **reduce or eliminate trade and other barriers** between them.

- There are various degrees of integration, depending on the type of agreement and the degree to which barriers between countries are removed.

Bilateral, regional and multilateral (WTO) trade agreements

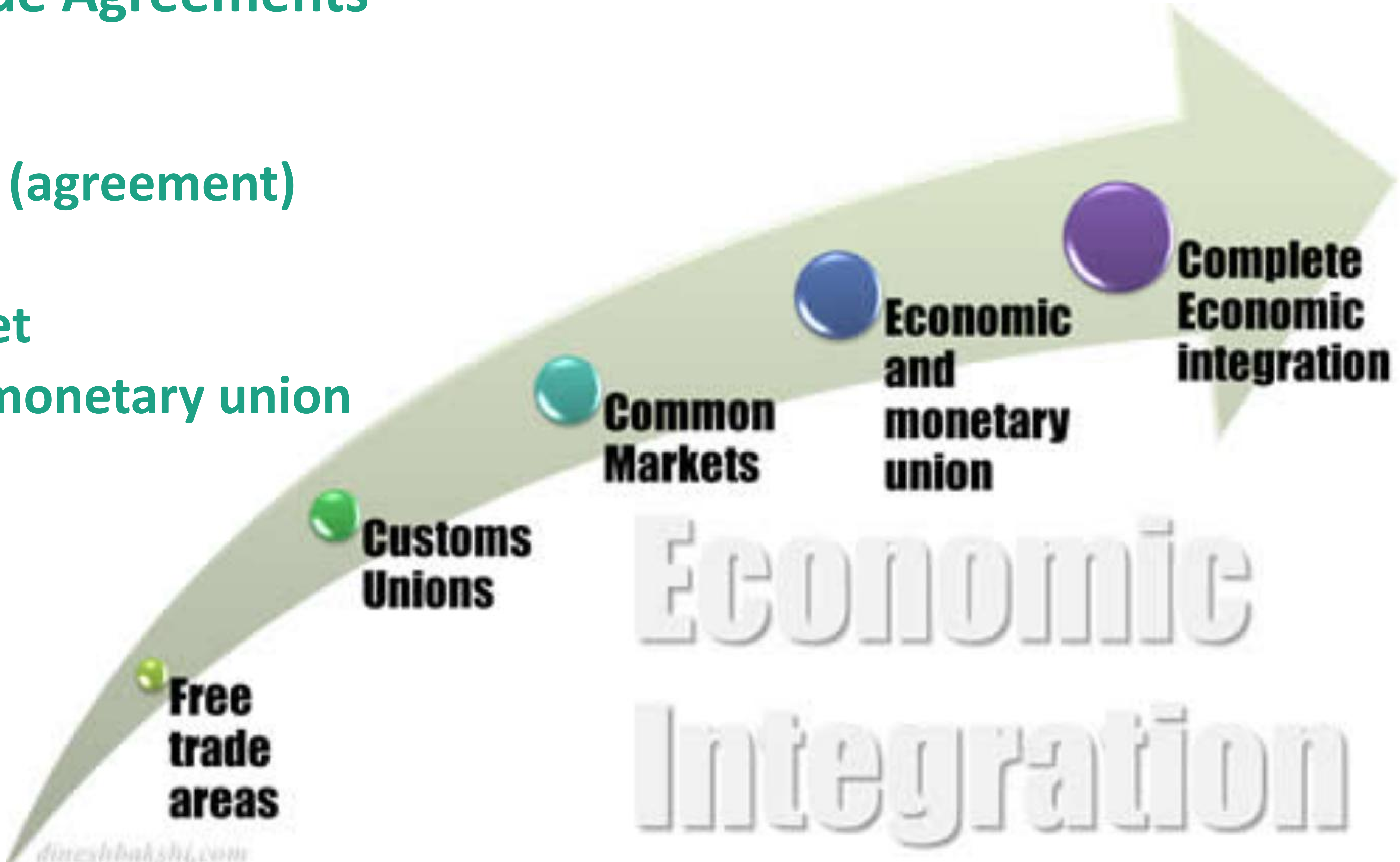
Objectives of trade agreement → promote **trade liberalization**, which is free (or freer) trade by reducing or eliminating trade barriers between members.

- A **bilateral** trade agreement is an agreement between two countries
- A **multilateral** trade agreement involves and agreement between many countries (WTO)
- **Regional** trade agreement is trade agreement between a group of countries that are within a geographical region.



Stages of international economics integration

- Preferential Trade Agreements
- Trading Blocs
  - Free trade area (agreement)
  - Custom Union
  - Common market
  - Economic and monetary union



Preferential trade agreement (PTA)

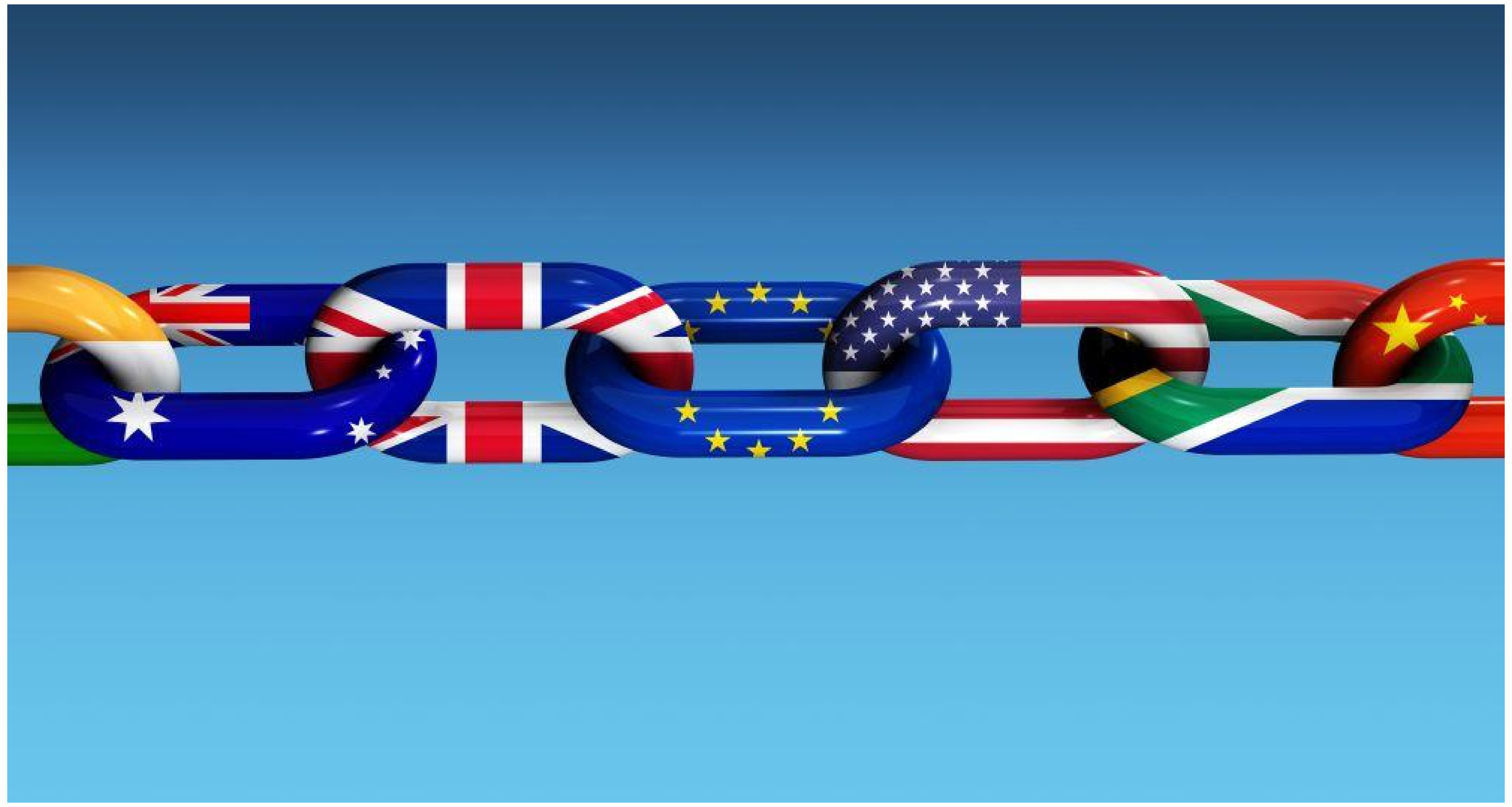
Preferential trade agreement (PTA) is an agreement between two or more countries to lower trade barriers on particular products in trade between each other.

- ✓ Easier access to the markets of other members for the selected products.
- ✓ PTAs sometimes involve co-operation between members on other issues, such as labour standards, environmental issues or intellectual property laws.
- PTAs may be bilateral (involving two countries) or regional (involving several countries)

Trading blocs

A **Trading bloc** is a group of countries that have agreed to reduce tariff and other barriers to trade for the purpose of encouraging free or freer trade and co-operation between them.

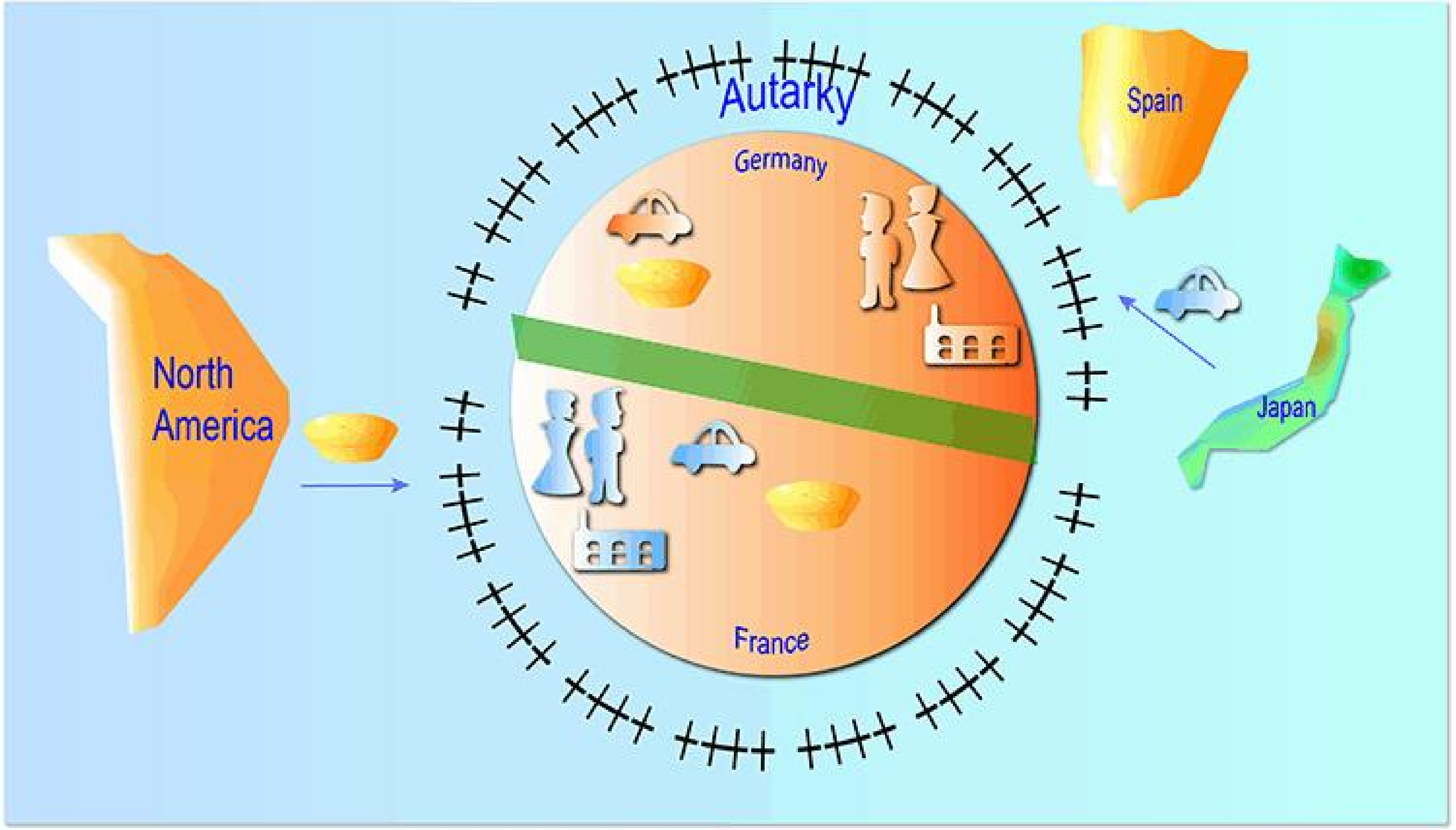
- From lowest to highest degree of economic integration:
    - Free trade area (agreement)
    - Customs union
    - Common market
    - Economic and monetary union

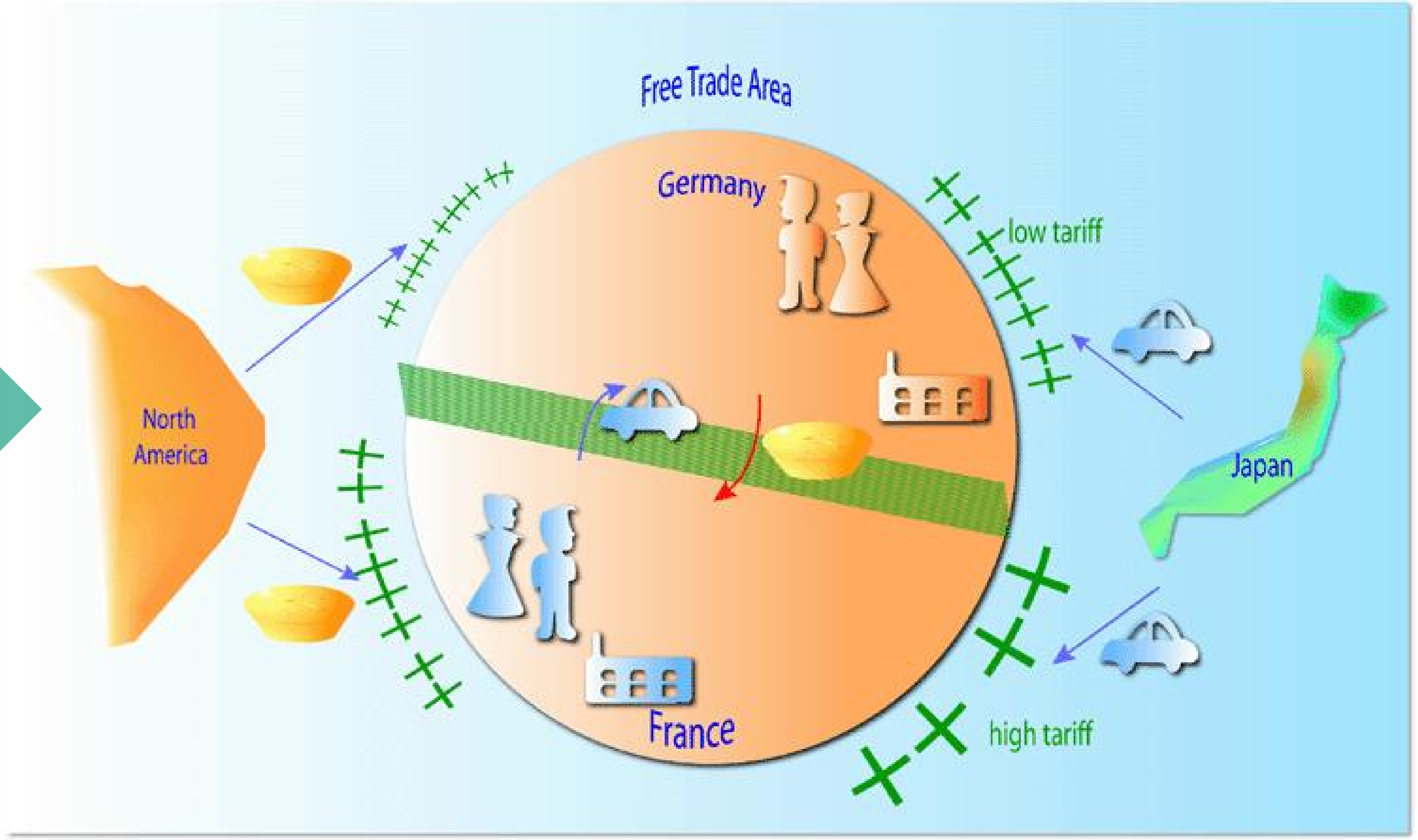


1. Free Trade Area (agreement) - FTAs

A free trade area (agreement) consists of a group of countries that agree to gradually **eliminate trade barriers** between themselves. It's the most common type of integration area.

- Each member country retains the right to pursue its own trade policy towards other non-member countries.
- There may be free trade in some products and some protection in other products between members.





1. Free trade area (agreement) - FTAs

Examples of FTAs:

- North American Free Trade Agreement (NAFTA)
  - Members: Canada, Mexico and United States
- Association of Southeast Asian Nation (ASEAN)
- South Asian Association for Regional Cooperation (SAARC)

Limitations:

- A product may be imported into the FTA by the country that has the lowest external trade barriers, and them sold to countries within the FTA that have higher external trade barriers. → it create difficulties for those countries with higher barriers, they may end up importing more of the good than they would like.
- FTAs make complicated 'rules of origin' for imports, designed to prevent goods from entering countries with lower external barriers.

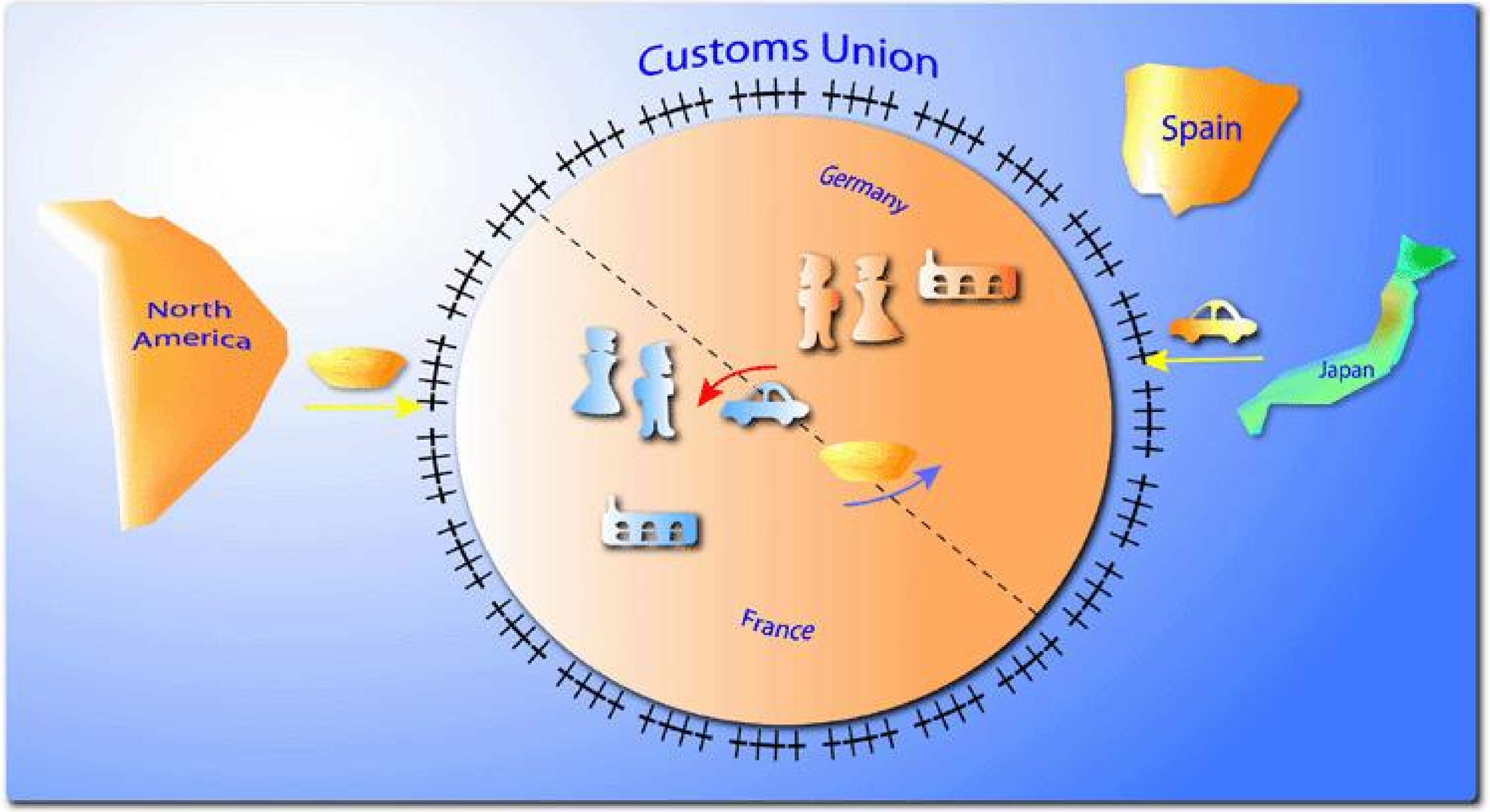
2. Customs union

A **custom union** consists of a group of countries that fulfils the requirements of a free trade area (elimination of trade barriers between members) and in addition adopts a common policy towards all non-member countries.

- The member countries of the customs union act as a group in all trade negotiations and agreements with non-members.
- Examples:
    - Central European Free Trade Agreement (CEFTA)
    - South African Customs Union (SACU)
    - Pacific Regional Trade Agreement (PARTA)

Benefits: no complicated ‘rules of origin’

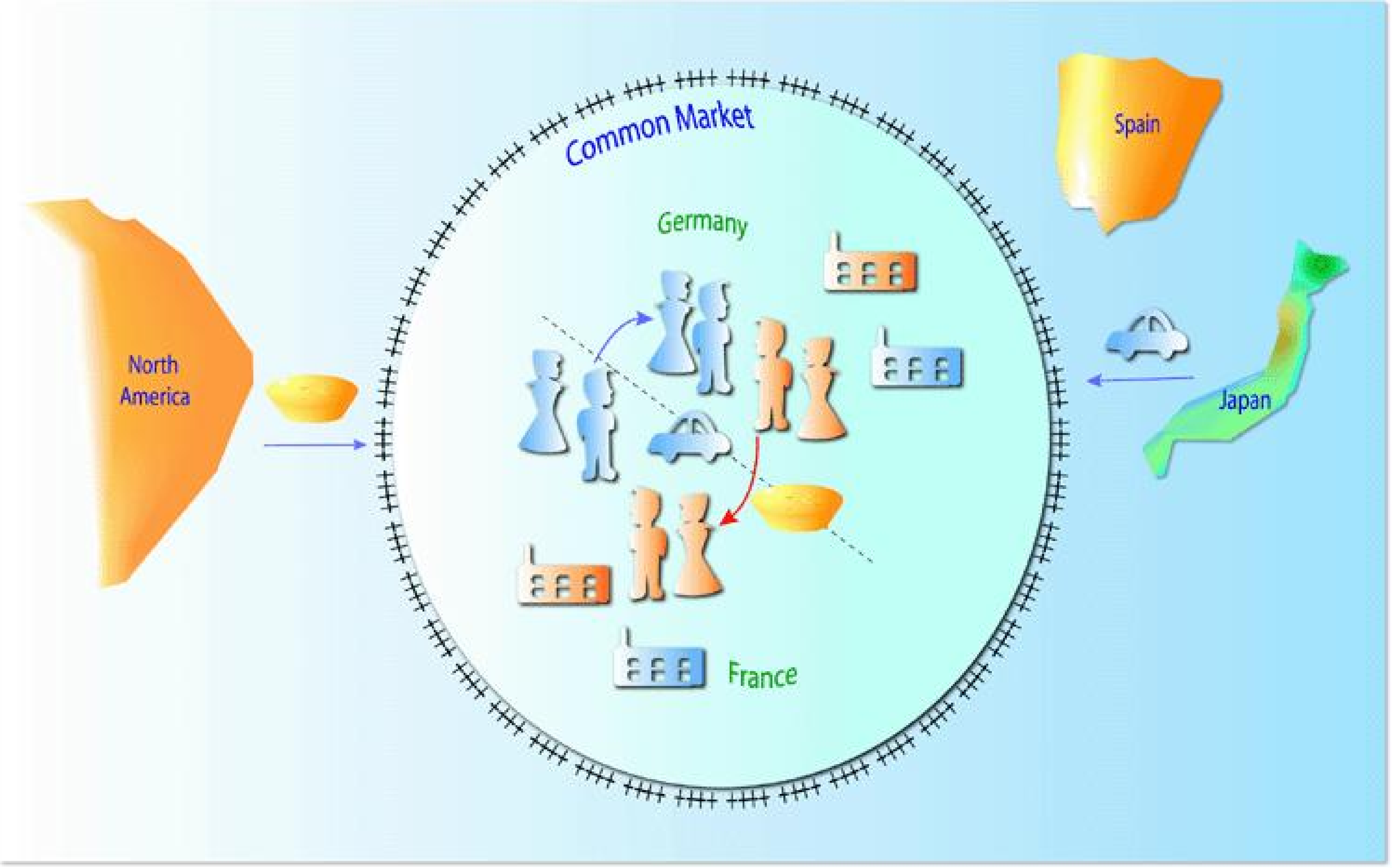
Limitations: member countries have to co-ordinate their policies toward non-members, this gives rise to the possibility of disagreements.



3. Common Market

A **common market** is an even higher degree of economic integration, in which countries that have formed a customs union proceed further to eliminate any remaining tariffs in trade between them; they continue to have a common external policy (as in a custom union), and in addition, they agree to eliminate all restrictions on movements of any factors of production within them.

- I.e. Labour are free to cross all borders and move, travel and find employment freely within all member countries. (same with all other factors of production)
- Examples:
  - European Economic Community (EEC, or the precursor of the present EU)
  - Caribbean Community (CARICOM)
  - Single Market and Economy (CSME)



3. Common Market

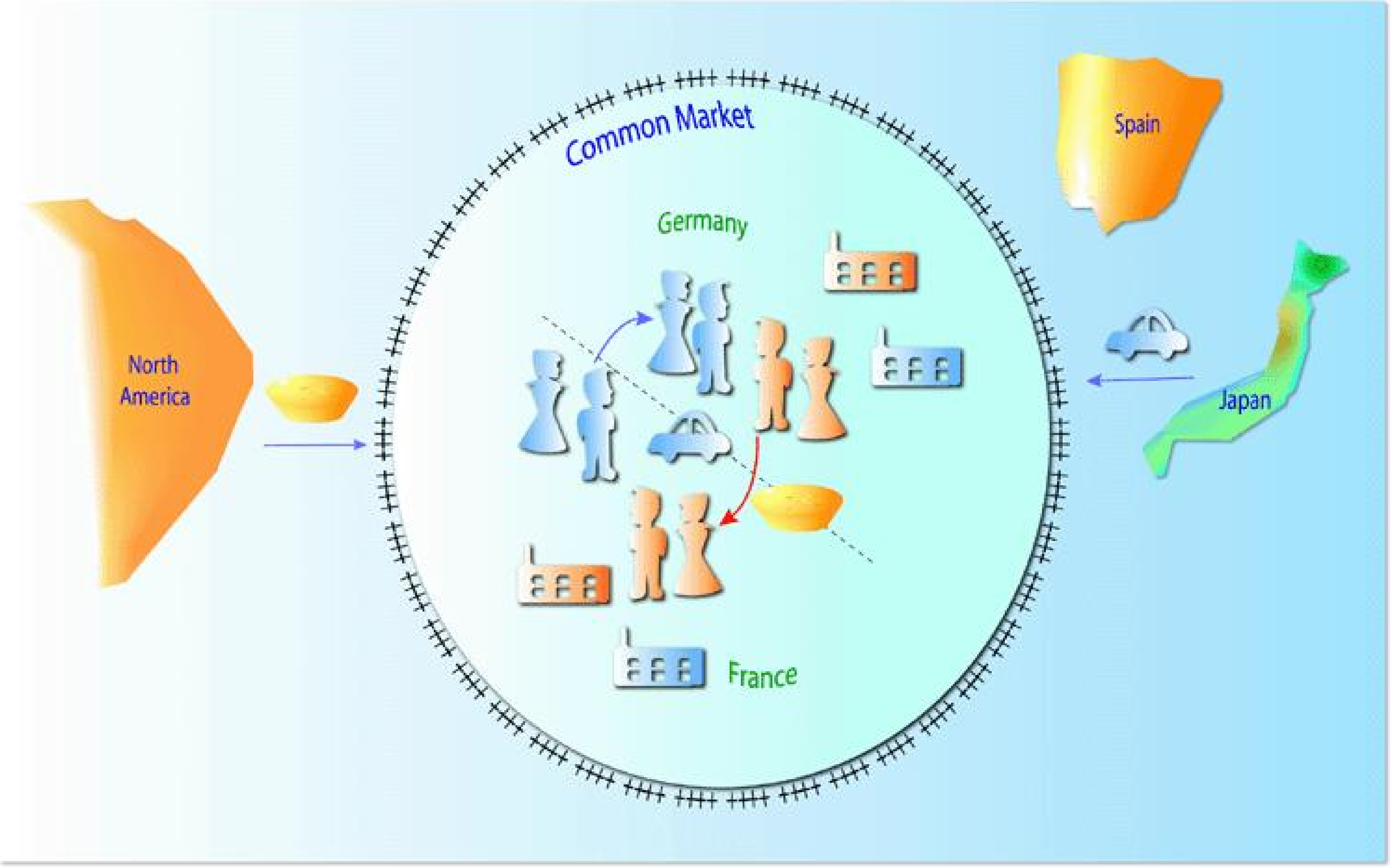
Benefits:

- A common market enjoy free trade and all its advantages.
- Factors including labour and capital are free to move/flow from country to country without restrictions → better use of factors of production → improve the allocation of resources.

Limitations:

- It requires even greater policy co-ordination among members than in a customs union.
- It requires the willingness of member governments to give up some of their policy-making authority to an organization with powers over all the member governments

→ difficult to accomplish, and need a long time for all countries to make the necessary policy changes to achieve co-ordination.



Evaluation of trading blocs(AO3)

- Trade creation
- Increased competition
- Expansion into larger markets
- Economies of scale
- Lower prices for consumers and greater consumer choice
- Increased investment
- Better use of FOP: improved resource allocation and greater employment opportunities
- Improved efficiency in production and greater economic growth
- Stronger bargaining power
- Political advantages

- Trade diversion
- Challenge to multilateral (WTO) trading negotiations (trade liberalisation)
- Unequal distribution of gains and possible losses
- Loss of sovereignty

Evaluating trading blocs - advantages

1 Trade creation

Country A

Price: $10

Tariff:$4

Country B

Price+tariff: $8+$4=$12

I will buy country A's Lego

Consumer in country A

Evaluating trading blocs - advantages

1 Trade creation

Country A

Free Trade

Country B

Price: $10

Price: $8

I will buy country B's Lego

Consumer in country A

Evaluating trading blocs – advantages (AO3)

1 Trade creation

- It refers to the situation where higher cost products (imported or domestically produced) are replaced by lower cost imports. (getting rid of disadvantages of tariffs)
- Greater efficiency in production
- Increase in consumption made possible by more imports
- Greater allocative efficiency and increasing social welfare.

Evaluating trading blocs - advantages

2 Increased Competition

- The removal of trade barriers within trading blocs results in increased competition among producers in member countries.
- Low or low barriers → import increase → force domestic producers to compete with lower cost producers from other countries.
- Production by more efficient producers
- Lower prices for consumers
- Improved allocation of resources.

Evaluating trading blocs - advantages

3 Expansion into larger markets

- The ability of firms to sell beyond their national boundaries, and increasing their exports.

4 Economies of Scale

- When an economy opens itself up to free trade with other countries, its exports are likely to increase and as the size of the market expands, the firms can take advantage of economies of scale and achieve lower average costs.

Evaluating trading blocs - advantages

5 Lower prices for consumers and greater consumer choice

- The elimination of trade barriers (along with increased competition and economies of scale) results in lower prices for consumers.
- Increased imports → a greater of variety of goods from which consumers can choose.

6 Increased investment

- Enlarged markets → increased investment by firms that want to take advantage of the larger market size.
- Both by:
  - firms originating from a country within the trading bloc and
  - by firms originating from a country that is outside the trading bloc (multinational corporations)
- Incentive for outsider firms: they escape the tariff or other protection that the trading bloc imposes on imports from outside.

Evaluating trading blocs - advantages

7 Better use of factors of production: improved resource allocation and greater employment opportunities

- The free movement of factors of production in common market, results in better use of these within the bloc.
  - Local unemployment workers can find jobs elsewhere with more employment opportunities
  - Capital can move freely in search of greater profits
  - Better allocation of resources.

8 Improved efficiency in production and greater economic growth

- Inefficient producers lose their protection → improved efficiency in production → more rapid economic growth

Evaluating trading blocs - advantages

9 Strong bargaining power

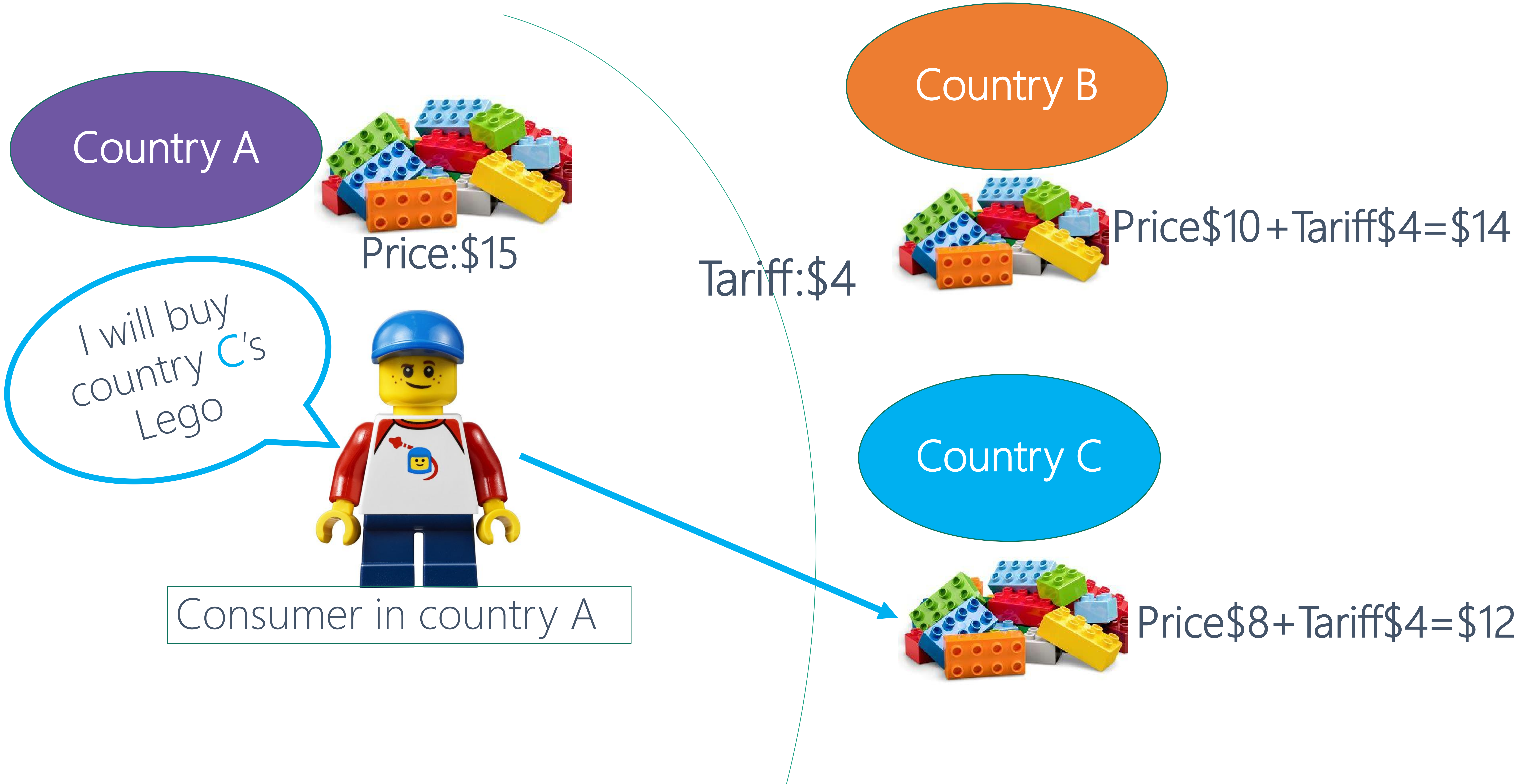
- Compare with individual country, of countries bargain as a trading bloc in multilateral negotiations, such as with the WTO, they have much greater power, increasing their chances of being heard and achieving their objectives.

10 Political advantages

- Greater economic integration is likely to result in a reduced likelihood of hostilities arising between countries whose economies are becoming more interdependent through increased trade, investment, labour and financial flows.
- Political stability as well as co-operation, resulting in further benefits for member countries.

Evaluating trading blocs - disadvantages

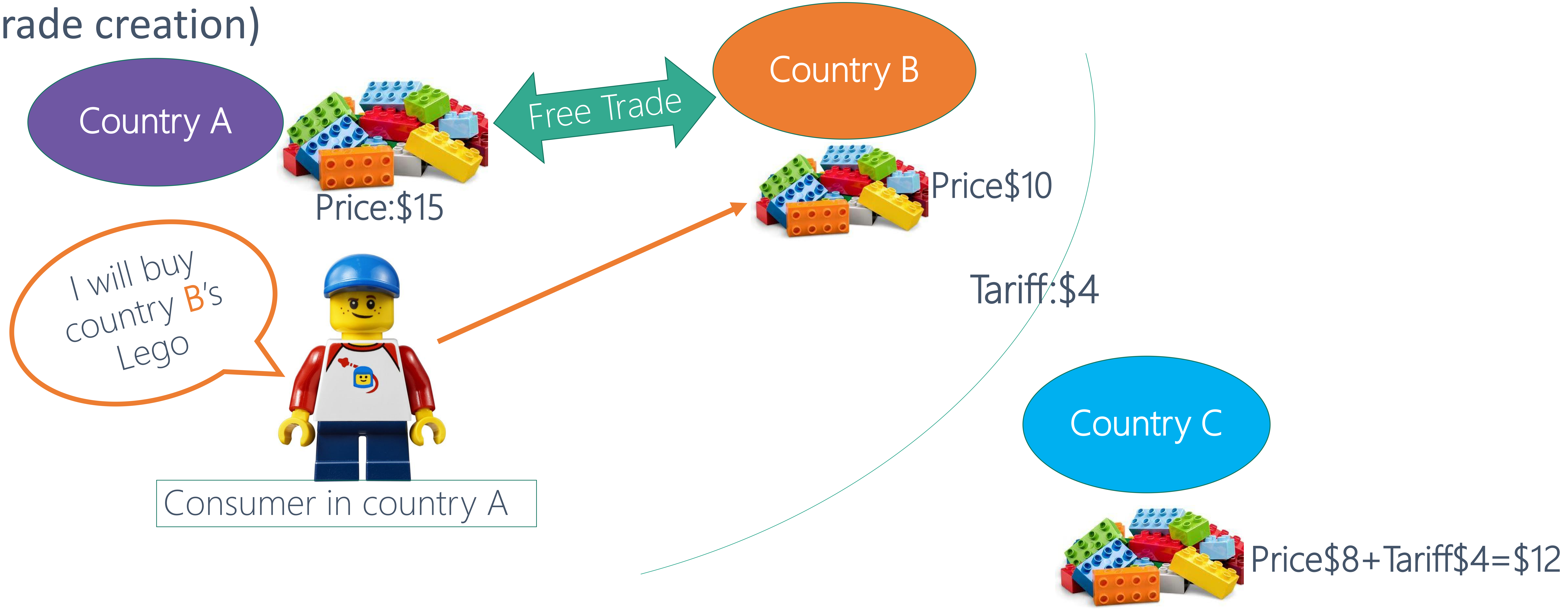
1 Trade diversion



Evaluating trading blocs - disadvantages

1 Trade diversion

- Trading diversion refers to the situation where lower cost imports are replaced by higher cost imports from a member after the formation of the bloc. (opposite of trade creation)



Evaluating trading blocs - disadvantages

1 Trade diversion

- Trade creation → increasing social welfare
- Trade diversion → decreasing social welfare

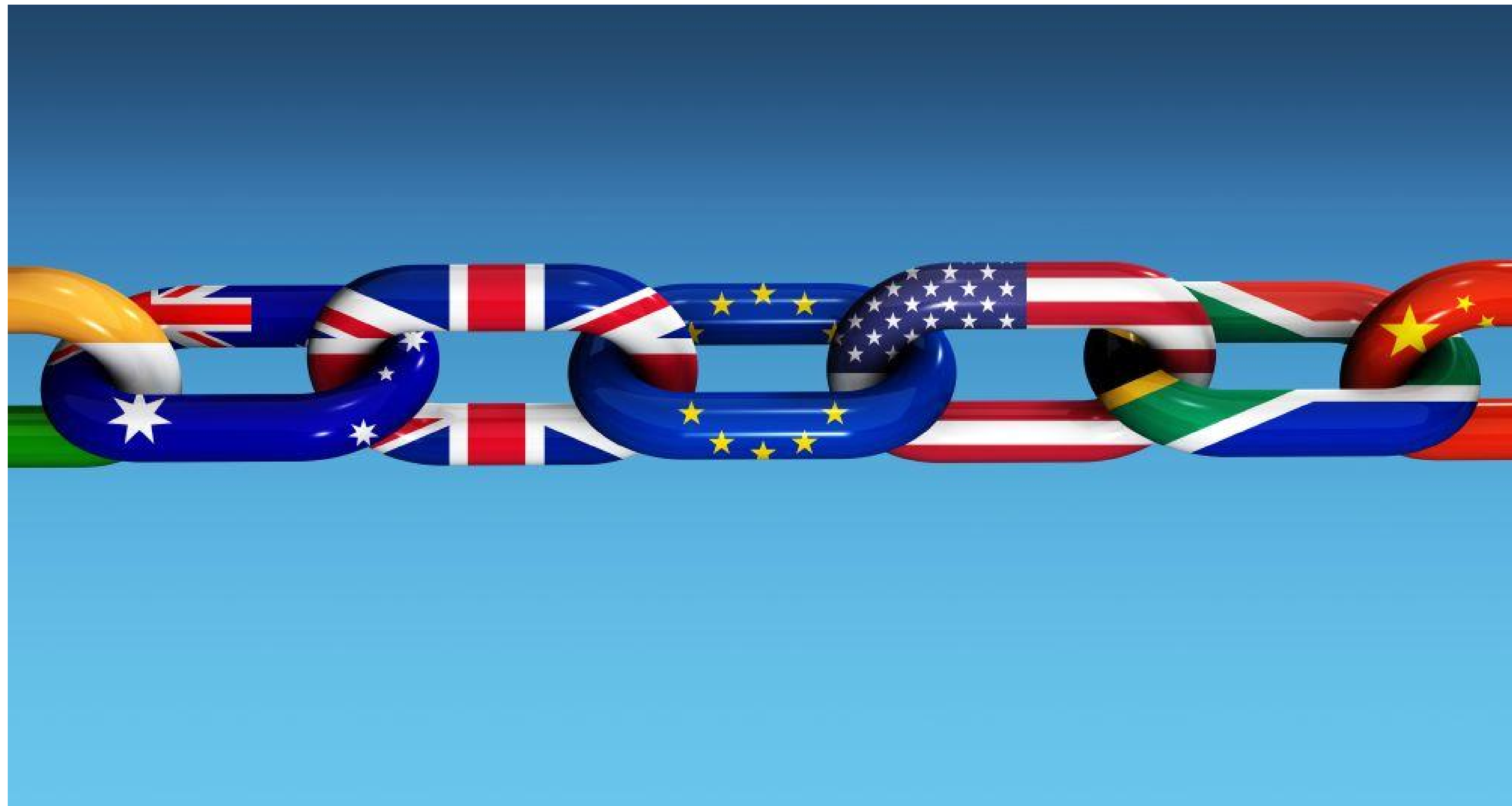
→Resource allocation will improve only if trade creation effects > trade diversion effect

- The possibility of trade diversion resulting from a trading bloc is an argument against trading blocs, and in favour of multilateral (WTO) trade liberalization. If all countries reduce their barriers at the same time, it is not possible for lower-cost imports to be replaced by higher-cost imports.

Evaluating trading blocs - disadvantages

2 Trading blocs may be a challenge to multilateral (WTO) trading negotiations (trade liberalization)

- The break-up of the world trading system into many blocs can create trade conflicts between different blocs that may slow down the process of global trade liberalization.
- Some large trading blocs enjoy free trade and all its benefits within the bloc, but may impose trade barriers on non-members → limit trade rather than to increase it on a global scale →worse global allocation of resources.



Evaluating trading blocs - disadvantages

3 Unequal distribution of gains and possible losses

- Countries forming a trading bloc are unlikely to gain equally from the operation of the trading bloc →potential for conflicts between the members, difficult to reach agreements.
- Within the trading blocs, some members may gain while others lose.

4 Economic integration involves a loss of sovereignty

- Sovereignty refers to authority over decision-making within the national economy.
- The higher the integration, the greater the loss of sovereignty.

Monetary Union

Monetary Union involves a far greater degree of integration than a common market, and occurs when the member countries of a common market adopt a **common currency** and a **common central bank** responsible for monetary policy.

- The most famous example: 'Euro zone countries' started from 1999. currently it consists of 15 countries. The European Central Bank responsible for monetary policy for all the member countries.
- 'Convergence Requirement' of member countries:
  - Limiting their rate of inflation
  - Limiting their budget deficit to 3% of GDP
  - Limiting their government debt to 60% of GDP, and so on.

- The monetary union is like a system of fixed exchange rate in some ways, the member countries adopt a single currency, it is as though they permanently fix the value of their currencies against each other, without any possibility of revaluating or devaluating their currencies.

Advantages of Monetary Union (AO3)

1. A single currency eliminates exchange rate risk and uncertainty.

- A common currency is used. It eliminates the risks associated with international trade due to exchange rate fluctuations and uncertainties.
- Benefits for importers and exporters, consumers and investors, thereby encouraging trade and investments across boundaries.
- More efficient allocation of resources.

2. A single currency encourages price transparency.

- **Price transparency** refers to the ability of consumers and firms to compare prices in all the countries that have adopted a common currency without having to make exchange rate calculations and conversions.
- Households, firms and tourists can easily compare the price of goods/services across different member states with currency conversions or dealing with fluctuations in the exchange rate.
- It can also promote competition and efficiency.

Advantages of Monetary Union (AO3)

3. A single currency eliminates transaction costs

- No conversion cost charged by banks.
- It results in significant savings that have the effect of encouraging trade, investments and international financial flows of all kinds.

4. A single currency promotes a higher level of inward investment

- **Inward investment** refers to investments from outsiders towards the member countries with a common currency.
- Inward investment increase due to the absence of currency risk within an expanded market, resulting in greater economic growth.
- Positive impact on economic growth and employment.

Advantages of Monetary Union (AO3)

5. Low rates of inflation give rise to low interest rates, more investment, increased output.

- Member countries committed to maintaining a low rate of inflation.
- More foreign direct investment between members of the monetary union and more inward investments from non-member countries
- Membership of a monetary union should be good for economic growth and job creation in the long-term.

Disadvantages of Monetary Union (AO3)

1. **A single currency involves loss of domestic monetary policy as an instrument of economic policy.**
   - For EU zone countries, monetary policy is the responsibility of the European Central Bank, the objective being price stability for the region as a whole.
   - Member countries cannot carry out its own monetary policies even under particular circumstances (higher or lower inflation, unemployment, etc., than the average of the euro zone countries).

2. **Monetary policy pursued by the single central bank will impact differently on each member country, depending on its own particular circumstances.**
   - Different countries have different degrees of inflation, unemployment, etc.
   - The actions taken by the common central bank in a monetary union will have an asymmetric impact on different countries owing to their varying circumstances.

Disadvantages of Monetary Union (AO3)

3. A single currency involves loss of exchange rates as a mechanism for adjustment.

- If a member country has a trade deficit with another member country, it no longer has its own national currency that could depreciate (in a flexible exchange rate system) or devaluate (in a pegged system) in order to correct the imbalance.
- With independence, outside of a monetary union, the country can depreciate its currency during a recession or to combat a current account deficit. (not possible in monetary union)

4. Fiscal policy is constrained by the convergence requirements.

- In EU, total public debt cannot be greater than 60% of GDP, the budget deficit of any year cannot be greater than 3% of GDP.

* Some refer it as an advantage because it promotes fiscal discipline, others view it as an disadvantage of authority restriction of the government.

Disadvantages of Monetary Union (AO3)

5. A single currency overseen by the single central bank involves loss of national governments authority in economic policy-making.

- Member countries are bound by agreements with other member states, no central bank for each member countries in its own.
- Authority is transferred away from democratically elected national governments towards an independent body that may be unelected.

→They have to give up the freedom and flexibility to adjust macroeconomic policies.

→They lose the autonomy to deal with their own specific economic problems.

- Possibility of a ‘fiscal union’ – higher form of economic integration with a central fiscal body with authority over all member countries.

Summary of the different stages of economic integration

Category	No internal trade barriers	Common trade protection policies	Factor mobility	Common currency
Free trade area	√			
Customs union	√	√		
Common market	√	√	√	
Monetary union	√	√	√	√

World Trade Organization

- WTO originated from the General Agreement on Tariffs and Trade (GATT) followed the Second World War and the Great Depression of the 1930s to rebuild economies and to promote economic co-operation and political harmony.
- WTO was established in 1995 by 124 member countries, Nowadays, WTO include 164 member countries around the world, they require all member countries to reduce trade barriers at the same time. → **trade liberalization**
- All signatory countries are required to grant "most favoured nation" status to all other member countries Largest international economic organization in the world and accounts for around 98% of world trade.

World Trade Organization - objectives

1. **Non-discrimination(the fundamental principles of WTO)** - a country cannot discriminate between any WTO members. It cannot impose higher barriers on imports from one country and lower ones on imports from another country.→ freer & fairer trade globally.(except for bilateral and regional trade agreements)
2. **More open** – encourage free international trade by being more open as an economy. – reduce and remove artificial trade barriers.
3. **Predictable and transparent** – by achieving 1&2, trade becomes more predictable and transparent → trade and investments are encouraged.

World Trade Organization - objectives

4. **More competitive** – it discourages unfair trading practices and protectionist measures (usually subjective and open to interpretation and debate)
5. **More beneficial for economically less developed countries** – give low-income countries more time to adjust to the rules, regulations and requirements of WTO membership. (3/4 members are developing countries)
6. **Protect the environment** – take necessary measures to protect member countries' natural environments and ecosystems, including aspects of public health, animal health and plant health. (same treatment for domestic firms and foreign businesses)

Functions and objectives of WTO

- **WTO functions and objectives:**

1. It **administers** WTO trade agreements
2. It provides a **forum for trade negotiations**. (discuss trade problems and negotiate trade agreements on how to liberalize trade)
3. It handles **trade disputes** – when WTO members disagree on trade issues, the WTO makes decisions to resolve the differences on the basis of the legal foundations of the trade agreements.
4. In **monitors national trade policies**. – WTO carries out periodic reviews of its members national trade policies.
   - Members are required to notify the WTO of any changes in trade policy.
   - The WTO examines new trading bloc arrangements.
5. It provides **technical assistance and training** for developing countries
6. It facilitates **co-operation** with other international organizations. (non-governmental organizations and charitable foundations, other international organizations, such as the world bank, IMF, OECD, etc.)

Criticisms of WTO

1. **The WTO is accused of promoting trade rules that do not favour developing countries.**
   - Developed countries received greater tariff reductions than developing ones.
   - The practice of making increased use of non-tariff and hidden barriers against developing countries exports was not sufficiently addressed.
   - The Uruguay Round provided for reductions in agricultural subsidies, these were not implemented because of resistance in developed countries.
   - Protection of intellectual property increased the costs of acquiring new technology by developing countries
   - Multinational corporations no longer had to buy their supplies locally; it may impact the local industry negatively. The demand for locally produced goods and services stop growing, thus would influence local employment negatively.

2. **The WTO has been unable to reach an agreement on agricultural protection and services.**
   - 2001 “Doha Development Round”
   - By the end of July 2008, the negotiations collapsed due to the inability to reach agreement on protection of developed country farmers.
   - Farmer protection continues in many developed countries (US, EU and Japan) – agreement in 2015 to phase out export subsidies.

Criticisms of WTO

3. The WTO is accused of no distinguishing between developed and developing economies

- The WTO treats all countries as if they are at the same level of development, with the sole exception of least Developed countries.
  - Some developing countries may need trade protection on the grounds of developing their infant industries or diversifying their production and economies to reduce reliance on primary products.

4. The WTO is accused of ignoring environmental and labour issues.

- **For environmental issues**
  - It has encouraged removal of trade barriers on imports from countries that have low environmental protection standards
  - It has not tried to reduce subsidies on activities that harm the environment such as agriculture, coal and transport.
- **For Labour issues**
  - The WTO ignored issues like child labour or other violations of internationally accepted labour standards.
  - The WTO has not linked the removal of trade barriers to improved labour practices.
  - Developing countries oppose the inclusion of labour standards in trade agreement, because they are afraid that this can be used as a type of ‘hidden’ protection.

Criticisms of WTO

4. WTO members have unequal bargaining power

- The WTO rule that each member country has one vote →democratic
- But economically powerful countries dominate agenda-setting and express opinions that carry greater weight. Less powerful countries often remain silent and give in to the demands of the more powerful in fear of possible retaliation.
- The formation of country coalitions which increases the power of the wealthier countries.
- Meetings that often restrict participation to the more influential and dominant countries.

5. The fragmentation of global trade

- The stalemate created by developed country demands that developing countries open up their markets to industrial products and services, while they themselves continue to offer protection to their farmers.
- The Plurilateral agreements which involve agreements by WTO members on a voluntary basis. It have been strongly criticized on the grounds that they will seriously undermine the multilateral approach of the WTO which involves participation in agreements by all member countries.

Criticisms of WTO

6. The blocking of its powers to resolve disputes

- One of the most important roles of the WTO → its ability to resolve trade disputes between countries that disagree on trade practice.
- The WTO has been carrying out this function through its “Appellate Body”, a committee of seven judges who hear complaints of WTO members against other WTO members with whom there are disagreements.
- U.S blocked the appointment of new judges of the Appellate Body in December 2019. If this issues is not resolved it is feared that as a result the WTO will be unable to continue to carry out this important function.