Economic Integration

Assessment Objectives

Specific Expectations	
AO1	Distinguish between preferential trade agreements: bilateral, regional, and multi-lateral.
AO2	Explain and provide examples of different types of trading blocs: free trade area/agreement.
AO3	Discuss the advantages and disadvantages of economic integration arising from the different types of trading blocs, free trade area/agreement, customs union, common market.
AO3	Discuss the advantages and disadvantages of economic integration arising from the different types of trading blocs
AO1	Explain monetary union.
AO3	Discuss the advantages and disadvantages of monetary union.

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 agreemnt and the degree to which barriers between countries are removed.
    1. Preferential trade agreement
    2. Free trade area
    3. Customs union
    4. Common market
    5. Economic and monetary union
    6. Complete economic integration

Preferential Trade Agreement

- **Trade liberalization** the policy of liberalizing (freeing up) international trade by eliminating trade protection and barriers to trade (tariffs, quotas, etc.)
- **Preferential trade agreement (PTA)** an agreement between two or more countries to lower trade barriers between them on particular products.
  - Trade barriers may remain on the rest of the products, and on imports from non-member countries.
  - Results in easier access to the markets of other members for the selected products, compared with the access of countries that are not members.
  - PTAs sometimes involve co-operation between members on other issues, such as labour standards, environmental issues or intellectual property laws.

Bilateral, region, and multilateral (WTO) trade agreements

- **Bilateral trade agreement** any agreement to lower international trade barriers involving two trading partners, usually two countries.
  - It may also involve a trade agreement between one country and another group of countries when this groups acts as a single unit (European Union).
- **Multilateral trade agreement** is a trade agreement to lower international trade barriers between many countries.
  - At the present time these are mainly carried out within the framework of the World Trade Organization (WTO), and involve agreements between WTO member countries.
- **Regional trade agreements** a trade agreement (or agreement to lower international trade barriers) between several countries that are located within a geographical region.

Trading Blocs

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

  1. **Free trade area (agreement)** – a type of trading bloc, consisting a group of countries that agree to eliminate trade barriers between themselves.
     - It is the most common type of integration area.
     - In trade relations between members, there may be free trade in some products, and some protection in other products.
     - Each country maintains the right to pursue their own trade policy towards non-member countries (to impose its own trade barriers).
     - One problem that arises in free trade areas is that a product may be imported into the FTA by the country that has the lowest external trade barriers, and then sold to countries within the FTA that have higher external trade barriers.

Trading Blocs

2. **Customs union** – a type of trading bloc, consisting of a group of countries that fulfil the requirements of free trade area (elimination of trade barriers between members) and in addition adopt a common policy towards all non-member countries.
   - Members of a customs unuon also act as a group in all trade negotiations and agreements with non-members.
   - Customs union have the advantage over FTAs that they avoid creating complication “rules of origin” for imports, since they all have the same common external barriers.
   - However, customs union face the problem of that they must co-ordinate their policies toward non-members.
3. **Common market** – a type of trading bloc in which countries that have formed a customs union proceed to eliminate any remaining tariffs in trade between them.

Trading Blocs

- They continue to have a common external policy (as in a customs union), and in addition agree to eliminate all restrictions on movements of any factors of production within them; factors affected are mainly labour and capital.
- Workers are free to move and work in any member country without restrictions, and capital (physical and financial) can also flow from country to country without restrictions.
- This results in a better use of factors of production and factor mobility across countries improves the allocation of resources.
- The development of a common market requires greater policy co-ordination among members, and requires the willingness of member governments to give up some of their policy-making authority to an organization with power over all member governments.

4. **Monetary union** – a high form of economic integration, involving the adoption by a group of countries of a single currency.

Trading Blocs

- The formation of a single currency can be partly thought of as a system of "fixed" exchange rates among participating countries, but one in which there is no possibility ever of changing the value of one currency in relation to another.
- Monetary union in addition involves the adoption of a common monetary policy carried out by a single central bank, which is necessitated by the use of a single currency.

Trading Blocs – Advantages

- Economic integration over the long term can be expected to bring forthe many benefits of free trade.

  1. **Trade creation** – the replacement of higher cost products (imported or domestically produced) by lower cost imports that results when a trading bloc is formed and trade barriers are removed.
     - In general, trade creation has the effect of increasing social welfare.
  2. **Increased competition**
     - Removal of trade barriers within trading blocs results in increased competition among producers in member countries.
     - Increased competition offers major advantages in term of production by more efficient producers, lower prices for consumers and improved allocation of resources.

Trading Blocs – Advantages

3. **Expansion into larger markets**
   - Arises from 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 firm can achieve lower average costs.
5. **Lower prices for consumers** & **greater consumer choice**
   - The elimination of trade barriers (along with increased competition and economies of scale) results in lower prices for consumers
   - Increased imports means a greater variety of goods from which consumers can choose.

Trading Blocs – Advantages

6. **Increased investement**
   - Enlarged firms often give rise to increased investment by firms that want to take advantage of the larger market size
   - A major incentive faced by outsider firms to set up production unit within the bloc is that they escape the protection that the trading bloc imposes from outside.
7. **Improved resource allocation & greater employment**
   - If a trading bloc develops into a common market, which involves free movement of factors of production, specifically capital and labour, there will also be a better use of these within the bloc.
   - Capital can also move freely in search of greater profits.
8. **Improved efficiency & greater economic growth**
   - Inefficient producers lose their protection, leading to better prospects for achieving more rapid economic growth.

Trading Blocs – Advantages

9. **Stronger bargaining power**

    - When countries bargain individually in multilateral negotiations, such as the WTO, they do not have much bargaining power especially if they are relatively small.
    - If they bargain as a trading bloc, 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.
    - Economic integration may lead to political stability as well as co-operation, resulting in further benefits for member countries.

Trading Blocs – Disadvantages

1. **Trade diversion** – the replacement of lower-cost products (imported or domestically produced) by higher cost imports that results when a trading bloc is formed and trade barriers are removed.
   - Trade diversion occurs when an importing country is forced to import from a higher cost producer within a trading bloc, whereas before it joined it was importing from a lower-cost producer elsewhere.
   - Resource allocation will improve only if trade creation effects are larger than trade diversion effects.
2. **Challenges multilateral trading negotiations**
   - Trading blocs are inferior to the WTO's multilateral approach of reducing trade barriers towards all countries.
   - Some large trading blocs may enjoy free trade and all its benefits within the bloc, but may impose high trade barriers on non-members, and the result may be to limit trade which may worse global allocation of resources.

Trading Blocs – Disadvantages

3. **Unequal distribution of gains**
    - Countries forming a trading bloc are unlikely to gain equally from the operation of the trading bloc, and this creates the potential for conflicts between the members.
    - It is also possible for some countries to gain while others become worse off in some respects.
    - The same applies to gains and losses within the member countries, as some stakeholders are likely to gain while others lose.
4. **Economic integration involves loss of sovereignty**
    - Sovereignty refers to authority over decision-making with the national economy.
    - The formation of trading blocs involves giving up some domestic decision-making power to a supranational authority.