## 3.4 Economic Integration

Introduction to economic integration
When two or more countries join formal agreements through which they commit to reducing or eliminating protectionist trade barriers on a group of products or all products, they are participating in **economic integration**. Economic integration takes many forms, from very low level agreements through which countries reduce tariffs on a small number of goods to complete economic integration, through which countries agree to completely free trade, free movement of labor and capital, and even share a common currency and monetary and fiscal policies.

Economic integration is a controversial issue in the 21st century, and in 2018, for the first time since the end of World War 2, more trade barriers are being erected between the world's largest trading nations than are being torn down. Under United States president Donald J. Trump tariffs have been placed on every one of America's largest trading partners and the United States has either withdrawn from or threatened to withdraw from some of its most significant free trade agreements. In response, America's trading partners have retaliated with new tariffs of their own on US goods.


The **trade wars** of 2018 represent a marked about turn on the path towards increased economic integration of the last several decades. In the coming sections, we'll examine the different forms of economic integration, outline their advantages and disadvantages, and look at who wins and who loses from freer trade between the world's economies.

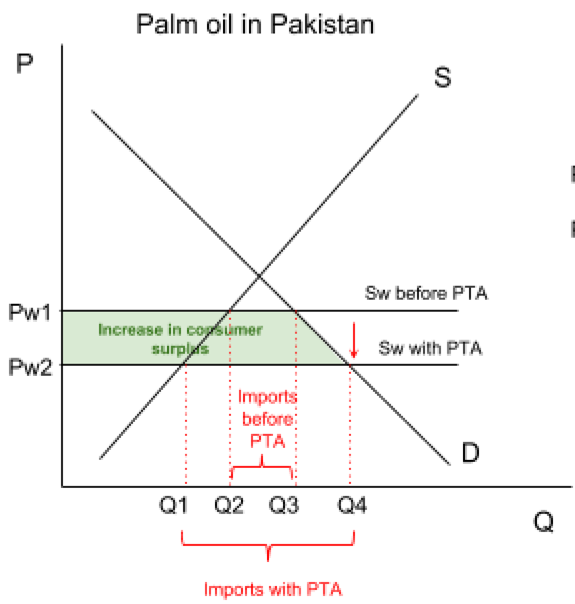
### Preferential trade agreements

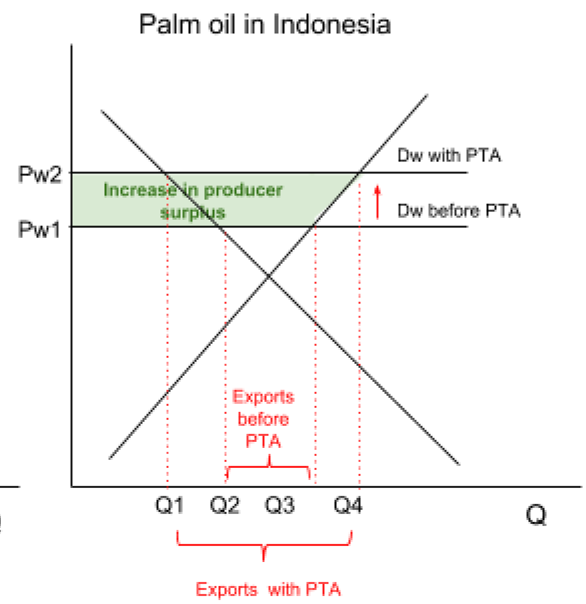
- Distinguish between bilateral and multilateral (WTO) trade agreements.
- Explain that preferential trade agreements give preferential access to certain products from certain countries by reducing or eliminating tariffs, or by other agreements relating to trade.

The lowest form of economic integration is a **preferential trade agreement (PTA)**, which is when two countries (a bilateral agreement) or more than two countries (a multilateral agreement) agree to reduce or eliminate tariffs on particular products. PTAs may also require elimination of quotas and subsidies on the products to which they relate.

The World Trade Organization (WTO) is an example of large, multi-lateral preferential trade agreement through which the 159 member countries (as of 2018) agree to the reduction of tariffs on most goods traded among member countries.

An example of a bilateral PTA is the agreement between Pakistan and Indonesia that includes several agricultural products, including palm oil. To increase the overall production and lower the prices of palm oil, Pakistan agreed to eliminate all tariffs on Indonesian palm oil. The effect of the PTA in the markets for palm oil in Pakistan and Indonesia can be seen below.




Observe from the graphs:

- The removal of tariffs on Indonesian palm oil causes the price of oil in Pakistan to fall from Pw2 to Pw1.
- Lower prices lead to more oil consumption in Pakistan (Q3 to Q4) and an increase in consumer surplus represented by the green area.
- Increased demand from Pakistan causes the world demand as seen by Indonesia increase from "Dw before PTA" to "Dw with PTA", increasing the price in Indonesia from Pw1 to Pw2.
- A higher price leads Indonesian firms to increase production from Q3 to Q4, leading to an increase in producer surplus represented by the green area.
- Pakistan imports more palm oil, Indonesia exports more palm oil, and there is an increase in total surplus in both countries.

The PTA has increased overall welfare in both Pakistan and Indonesia and resulted in a higher total level of palm oil production and a more efficient allocation of resources. Pakistan will use less of its scarce land to produce a product that it is not particularly good at producing, while Indonesia will allocate more land to palm oil production, in which it has a comparative advantage.

Of course, some stakeholders are worse off because of the PTA.

- Pakistani producers sell less oil at a lower price as imported oil crowds out domestic production.
- Indonesian consumers will buy less domestic oil at a higher price, as exports crowd out domestic consumption.

## Trading blocs

- Distinguish between a free trade area, a customs union and a common market.
- Explain that economic integration will increase competition among producers within the trading bloc.
- Compare and contrast the different types of trading blocs

HL only objectives:

- Explain the concepts of trade creation and trade diversion in a customs union.
- Explain that different forms of economic integration allow member countries to gain from economies of scale.

PTAs are a just the lowest level of economic integration. When two or more countries agree to eliminate tariffs on ALL good traded between them, they have joined what is known as a **trading bloc**. There are three kinds of trading blocs, ranked below from the lowest to the highest level of economic integration.

| **Trading blocs** | | |
|---|---|---|
| **Type** | **Includes..** | **Examples** |
| **Free trade area** | removal of tariffs on all goods (and some services) | The North American Free Trade Agreement (NAFTA - Canada, the United States, and Mexico) |
| **Customs union** | removal of tariffs on all goods (and some services), and... common external tariffs on goods from non-member countries | Southern African Customs Union (SACU - Southern Africa: Botswana, Lesotho, Namibia, South Africa, and Swaziland) |
| **Common market** | removal of tariffs on all goods and services, and... common external tariffs on goods from non-member countries, and... free flow of labor and capital between member countries | The East African Community (EAC - Burundi, Kenya, Rwanda, South Sudan, Tanzania, and Uganda) |

Notice that each level of trade bloc builds on the lower level. A customs union IS a free trade area in which there are common external tariffs. A common market IS a customs union in which there is free flow of capital and labor.

Effects of trade blocs

Economic integration through the removal of tariffs and increased movement of labor and capital will have several effects on various stakeholders in the member countries:

- Increased competition between producers
- Lower prices for consumers
- Greater efficiency

Trade creation versus trade diversion (HL only)

When countries join a customs union, many of the benefits of freer trade may be enjoyed between the member countries, but it is also possible that a less efficient allocation of resources could result from the implementation of common external tariffs on non-member countries.

For example, consider the Southern African Customs Union, which includes Botswana, Lesotho, Namibia, South Africa, and Swaziland (see map below).


Let's assume that before the formation of the customs union, the five member countries all had their own tariffs on one another's goods and on other countries' goods, such as Zimbabwe (which is not part of the union). Assume also that Zimbabwe is the most efficient producer of cotton in southern Africa. The other countries all produce cotton as well, but at a higher cost per unit than Zimbabwe.

With the formation of the customs union, the five member countries agree to remove tariffs on cotton between one another, but agree on and establish a common tariff on cotton from Zimbabwe. Assume that of the five member countries, South Africa produces cotton most cheaply. As a result of the customs union, South Africa will produce more cotton and export it to the other four, **creating trade** within the customs union. However, less cotton will be imported from Zimbabwe, as trade is **diverted** from a low cost country (Zimbabwe) to a higher cost country (South Africa).

**Trade creation** refers to the effect of a customs union that results in a good's production shifting from a high cost country to a low cost country. When production shifts from Namibia, Botswana, Swaziland, and Lesotho to South Africa, trade is created.

**Trade diversion** refers to the effect of a customs union that results in a good's production shifting from a low cost country to a high cost country. When production shifts from Zimbabwe to south Africa as a result of the common external tariffs on Zimbabwe's cotton, trade is diverted.

Trade creation increases allocative efficiency within member countries of a customs union. Trade diversion reduces allocative efficiency, as production shifts from more efficient producers to less efficient producers.

## Monetary union

- Explain that a monetary union is a common market with a common currency and a common central bank.
- Discuss the possible advantages and disadvantages of a monetary union for its members.

The highest level of economic integration in which sovereign countries can participate is **monetary union**, which is created when members of a common market share a single currency, a single central bank, and monetary policy.

The most prominent monetary union is the Eurozone, which includes 19 of the 28 countries in the European Union (EU), which in turn are part of the European Economic Area (EEA), a common market which includes the 28 EU countries plus Iceland, Liechtenstein, and Norway.

Figure 1: European Economic Area common market (blue and green countries)

Figure 2: Eurozone monetary union (blue countries)

Eurozone countries share a single currency, the euro, the supply of which is controlled by a single central bank, the European Central Bank.

Advantages of a monetary union

Joining a monetary union allows a country to enjoy completely free trade in goods and services, free movement of labor (workers can travel across country borders for work), and free movement of capital (firms can build factories and invest in assets across borders). In addition, a shared currency removes all remaining possible barriers to trade, as countries can no longer intervene in their forex markets to give their exporters or importers an unfair advantage over foreign competition.

Monetary unions are therefore the highest level of economic integration possible without countries abandoning their national governments' abilities to control fiscal policy. Advantages of monetary union include:

- Increased allocative efficiency across member countries (trade creation)
- Increased competition
- Larger export markets
- More product variety and lower prices for consumers
- More employment opportunities for workers who can travel across national borders for work
- Greater access to labor and capital for firms wishing to increase output
- Economies of scale for firms producing for a larger market

Despite the advantages, monetary unions do have their disadvantages for both member and non-member countries.

- Trade diversion may result as member countries place common external tariffs on

non-member states
- Loss of economic sovereignty as national industries are increasingly owned by foreign businesses and investors
- Downward pressure on wages as increased size of the labor force increases competition in labor markets
- Loss of monetary sovereignty as countries' central banks are disbanded in favor of the currency union's central bank
- Loss of ability to manage the currency's exchange rate as foreign exchange policy is determined by the currency union's central bank

The main disadvantages arise from the loss of economic sovereignty. Of course, some of these disadvantages can be thought of as secondary to the economic advantages of increased integration and greater efficiency in resource allocation. For example, the nationality of a factory's owner should be less important from an economic perspective than the efficiency with which the factory produces its output, the employment opportunities it creates, and the contribution to overall output it provides.

Beyond monetary unions, the highest level of economic integration is **complete economic integration**, which essentially describes a sovereign country's national economy. For example, the 50 states of the United States of America are completely economically integrated. The United States enjoys:
- Completely free trade in all goods and services
- Free movement of capital and labor across states lines
- Common external tariffs set by the US federal government
- A single currency managed by the US Federal Reserve Bank
- A single federal government determining fiscal policy for all 50 states, collecting taxes and spending on public goods and transfers benefiting the entire country.

The essential difference between the United States of America and the 18 Eurozone countries is that the US has a single fiscal authority that can tax all US citizens and provide goods and services to all US citizens. In contrast, a citizen of one Eurozone country (say, Greece) pays taxes to her own government and is eligible to receive benefits from her own government, but does NOT pay taxes to other Eurozone countries' governments and does not receive benefits from those governments. A Greek citizen cannot collect a pension in her old age from the French government.

Eurozone countries' governments manage their own national budgets and can run surpluses or deficits based on their own fiscal priorities. Individual American states, on the other hand, must balance their budgets each year because they cannot issue bonds to finance deficits as national governments can.

The fiscal sovereignty of countries in a monetary union brings up one last disadvantage of such agreements: if individual countries are fiscally irresponsible (e.g. run persistent, large budget deficits), the very legitimacy of the currency union could be undermined, affecting the economies of all other member countries. By joining a currency union with 18 other countries, a new Eurozone economy is putting faith in the governments of its 18 currency partners to maintain relatively balanced budgets and not drive up their national debts to a level that threatens the stability of the currency.

The Eurozone financial crisis of 2011 demonstrated the risks to countries that had joined the Eurozone, when five member countries (Portugal, Italy, Ireland, Greece, and Spain) ran up deficits that spooked international investors and threatened the stability of the entire monetary union.