International Business

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Lecture - 49
Regional Economic Integration

Welcome friends. So, I welcome you again to the course of International Business. So, I think today we are going to start our a new unit all together which is called the Regional Economic Integration, right.

So, by now I think you must be very clear how important trade is and why it is important for countries to open up their economies and from a closed economy they need to move to an more open economy. The simple reason is that you know as trade becomes more prosperity rises right.

But there is not you know on the other side there can be an argument against globalization also, but we have seen that as you know through research also it has been marked; that as you know trade increases countries tend to gain right.

So, the best thing that anybody could think of ever doing trade is always with our nearest you know countries. So, regional economic integration is basically an idea which talks about the same concept of how countries can come together or you know nations can come together and have a you know policy a common policy for them so, that they can make trade much easier right.

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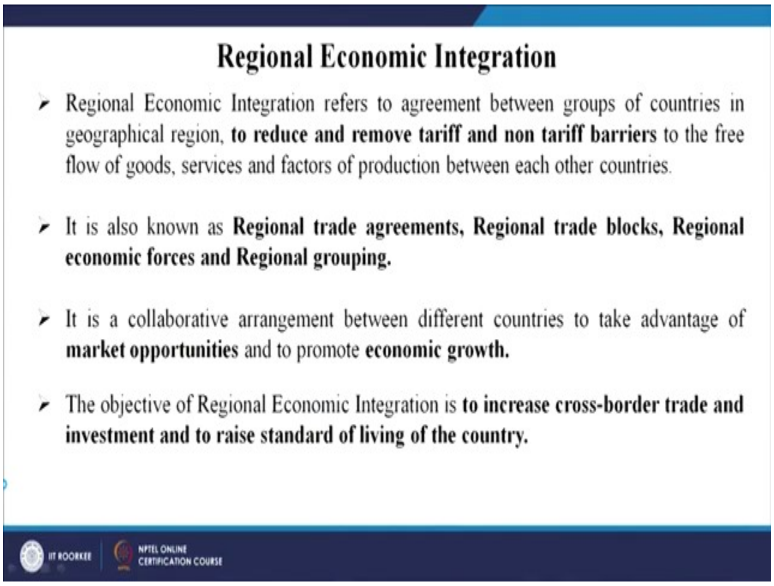

So, let us see what exactly the definition says. Regional economic integration refers to an agreements between groups of countries in geographical regions, to reduce and remove tariff and non tariff barriers. So, we have seen that you know there are tariff and non tariff barriers which always tries to hindrance the flow of trade right.

So, the major idea of this regional economic integration is to reduce and remove those tariff and non-tariff barriers right. Sometimes it has been observed that tariff which is the monetary barriers are still ok, but non-tariff barriers like for example, you know the policies, the guidelines, you know the paperwork they are even tougher and more complicated right.

So, the idea is to remove or either you know reduce it. So, that there is a free flow of goods, services and the factors of production between the member nations ok. It is also known as regional trade agreements, trade blocks or regional economic forces and regional grouping. So, you can call it in different names right, but the idea is the same.

It is also said as to be a collaborative arrangement between different countries to take advantage of the market opportunities and to promote economic growth. So, why trade blocks have been forms? So, the idea was very simple that whenever there is a you know there are when different members countries when that countries are in isolation; so for any trade there has to be a lot of policy you know that lot of paperwork, there is a lot of you know different conditions which have to be fulfilled. So, that makes trade very complicated and very difficult.

So, in order to make a smooth flow; if countries could come together or nations could come together and behave as if there is a common you know kind of a common spirit or a common market then, the flow of trades and services could become much easier; and as it becomes easier, it seems to be like more of like a common market or a one single market unified market. So, that is the whole idea why this things have grown right.

The objective of this is to increase cross border trade and investment and to raise standard of living of the country. So, the whole idea is that, the advantage from one country moves to another country and in the process as we have seen through Ricardo's comparative advantage theory and Adam Smith's theory we have seen that, as you know trade will happen; countries which are you know now poorer condition or the people are living in a poor you know the standard of living is poor, they also tend to gain.

In fact, interestingly one research says that when there is a you know it was Samuelson's research in which he said that, whenever there is a you know trade between a richer country and a poorer country; it is not that the richer country will tend to gain which is generally an hypothesis we make, but in many a cases for example, if the country is in a well the Ricoh system if the country is well developed in the poorer country, then it is in this condition; the poorer country tends to gain more in comparison than the to the richer country right.

For example, if a if Samuelson's idea could be taken further we can understand that, if today India and US will trade, then it is not US which will gain rather that will be India will which will gain, but the condition is that India's ecosystem or the logistics supply chain systems have to be very robustly designed for that.

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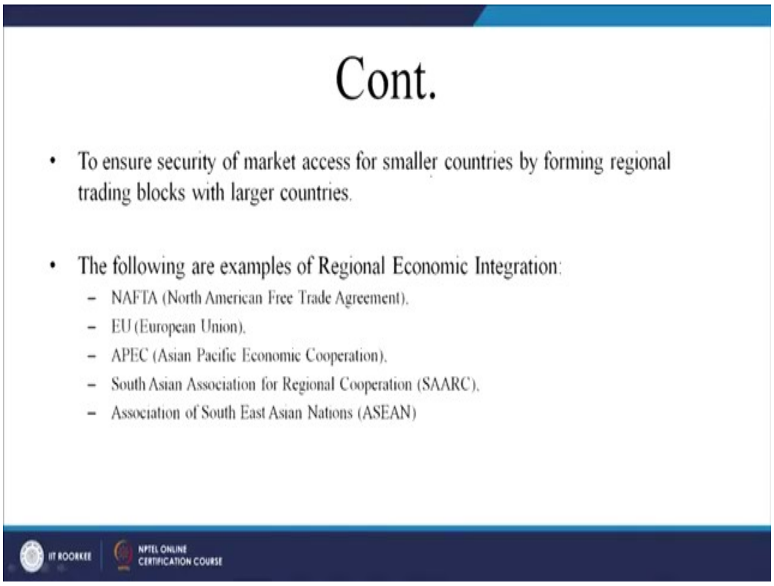

To ensure security of market access for smaller countries by forming trade blocks with the larger countries. This is also a idea behind the regional economic integration. Some of the examples are very popular ones for example, the NAFTA, North American Free Trade Agreement right; European union. So, we must be hearing a lot about the European Union in the recent times because of the Britain's exit right; which is largely called Brexit.

Then you have APEC, which is Asia Pacific Economic Cooperation right. South East South Asian association for Regional Cooperation which is SAARC, popularly known as SAARC. So, SAARC summit you must have heard. Association of South East Asian Nations or ASEAN right. So, these are the different kinds of regional economic integrations.

Now, there is a different levels in which free trade this regional economic integration or the trade blocks have been leveled.

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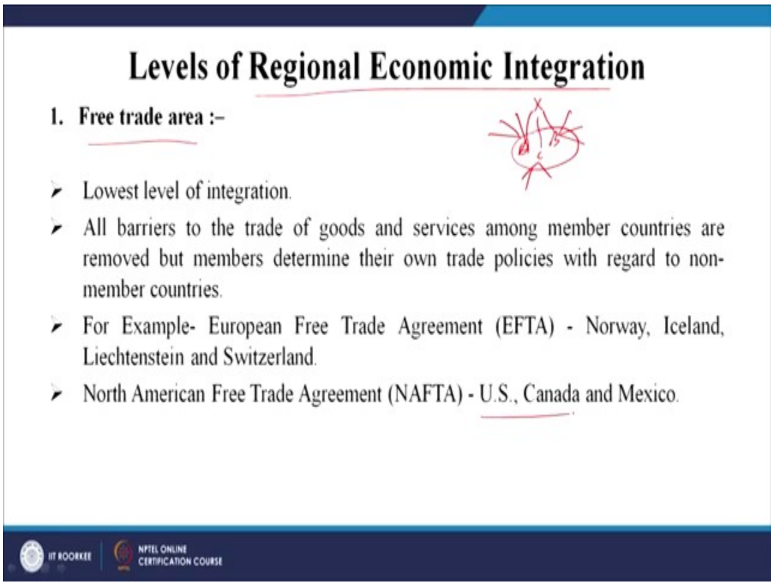

So, we will start with the most basic one which is called the free trade area and then we then move on to the more you know sophisticated ones. So, the most basic level of regional economic integration is called the free trade area right. It is the lowest level of integration. Here all the barriers to the trade of goods and services among the member countries are removed, but members determine their own trade policies with regard to the non-member countries.

So, what happens? For example, if there are a member countries right. So, there as different member countries let us say A, B and C. So, among these countries there is no barrier, but each country can formulate its own policy with other countries. So, for a common country X, B can have a different policy, A can have a different policy, C can have a different policy right.

Example of this is European free trade agreement which was the most basic one which started with right. And it had member countries like Norway, Iceland, Liechtenstein and Switzerland right. In fact, it started with 7 countries and out of which 3 later on joined the European Union ok. Another one is the NAFTA, the North American Free Trade Agreement which has US, Canada and Mexico.

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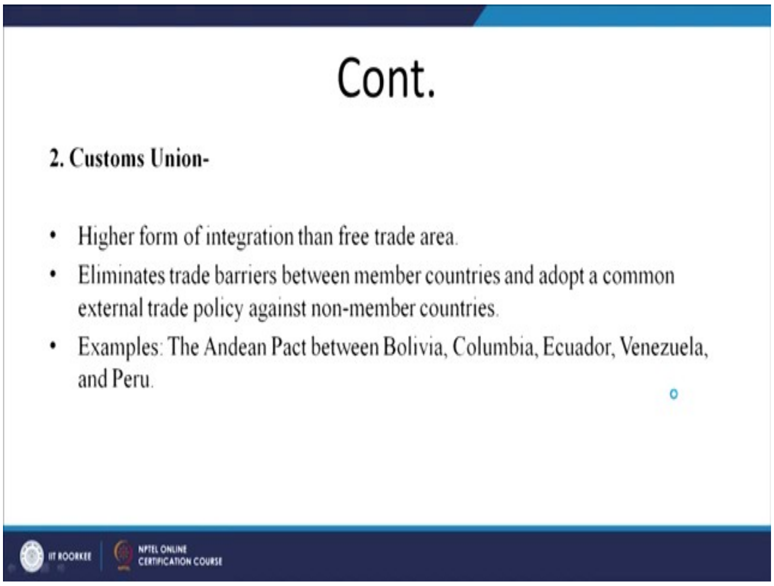

So, the next one as we move off from the free trade area is called the customs union right. As it says, it is a higher form of integration than the free trade area and why it is one level up because, it eliminates the trade barriers between the member countries not only that which this was also there in the free trade area.

But, it adopts a common policy, external trade policy against the non-member countries. So, as you saw here; that here every country was free to have a different policy with X right , but in this case when you come to the customs union we have a common external trade policy against the non-member countries.

So, one of the example is the Andean Pact between Bolivia, Columbia, Ecuador, Venezuela and Peru right. So, these countries have made this pact and they are termed as a customs union right.

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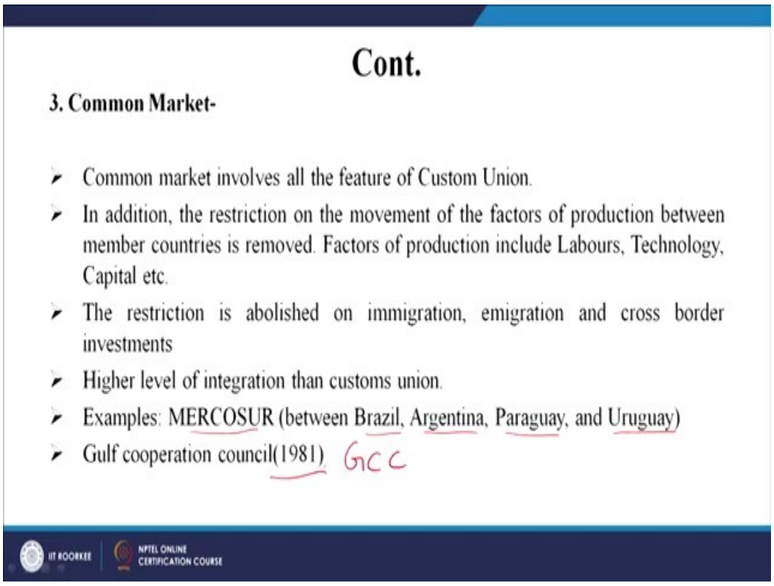

So, the next one is the common market right. The common market actually it has all the features of the free trade area as well as the customs union right. Now, as it says in addition that you know the added feature here is that it rest it; the restriction on the movement of the factors of production between the member countries is completely removed in this case.

So, the factors of production basically are like land, labor, capital right technology. So, these are again this as this is given a very free movement, that is why in the case of customs union you know and free trade area when FDI and other things were becoming very tough; it becomes more simpler in a common market case ok.

The restriction is abolished on immigration, emigration and cross border investments ok. That is what I was talking about the FDI. Higher level of integration then customs union as you had seen in the last, the Indian pact and all you had seen.

One example of the common market would be the MERCOSUR which is a pact between Brazil, Argentina, Paraguay and Uruguay. Another most many more popular one is the Gulf Cooperation Council largely called as GCC right which was established in 1981 and it has 6 member countries right; like Saudi Arabia, Kuwait, Bahrain, Qatar, UAE and Oman.

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Now, the whole idea of this GCC is to create another kind of a European Union. So, among the member you know the mostly the Islamic nations and the you know the in the Gulf, so they want to create a similar kind of a situation right; and even they intend to have one common you know currency even, which they are trying to work on it, but it has not been successful yet right. Two new members were have attempted to come in; one is Jordan and other is Morocco right.

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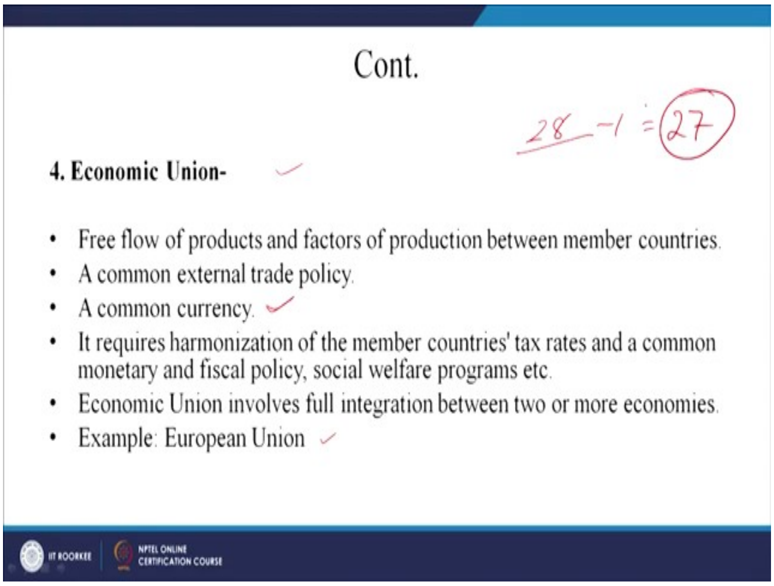

The next in the you know as you grow up from the free trade area, then the customs union and then the common market; the next is the economic union. Now, what happens here is that there is a free flow of products and factors of production between the member countries and, a common external trade policy and a common currency.

So, this is the one extra feature; which the common market did not have. It requires harmonization of the member countries' tax rates and a common monetary and fiscal policy, social welfare programs etcetera right.

So, the economic union talks about a little much higher because, the countries have to think about a common economic policy as such right. So, the monetary and the fiscal policy has to be common. Economic Union involves full integration between two or more economies. So, example is the European Union.

So, at the moment the European Union as you know, Britain has just recently come out of it right in on January 2020. So, earlier there were around 28 countries including UK minus 1; so now, there are 27 nations; which are part of the economic union.

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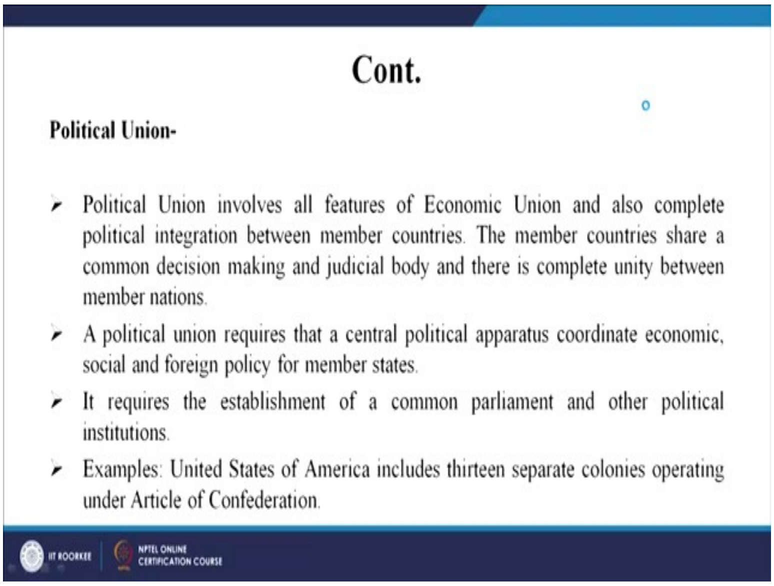

The next is a quite a idealistic situation which is called the Political Union. Now Political Union involves all features of the economic union and also a complete political integration between member nations ok. The member nations share a common decision making and judicial body and there is complete unity between the member nations ok.

This requires that a central political apparatus coordinate the economic, social and foreign policy of the member states. And, it also requires the establishment of a common parliament and other political institutions. Recently, example the United States of America includes 13 separate colonies operating under the article of confederation. But you know political union because is a very tougher task and it is very highly an Utopian state which is very difficult to achieve right.

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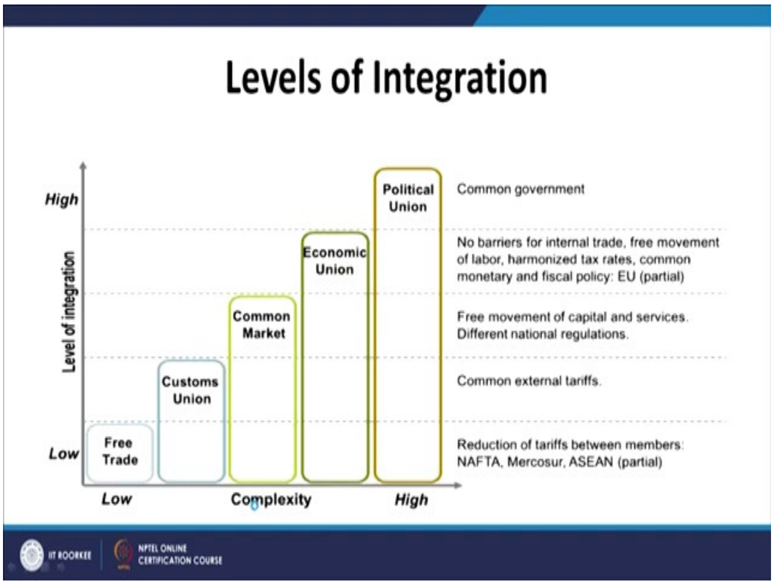

Now, through a common diagram you can see how this is you know the level of integration low and high and as terms of complexity low and high. So, the free trade area is at the bottom; which has a low level of integration and low complexity also. And then you have the next which is the customs union, slightly higher level of integration and higher level of complexity.

Then you have the common market which is more complex and but a higher integration. Then economic policy, which is very high level of integration, but the complexity is also very very high now. And obviously, political union is the highest right; as you can see common government.

So, in the political union, no barriers for international internal trade, free movement of labor, the harmonized tax rate, common monetary and fiscal policy; we just studied all these things are in the level of integration right.

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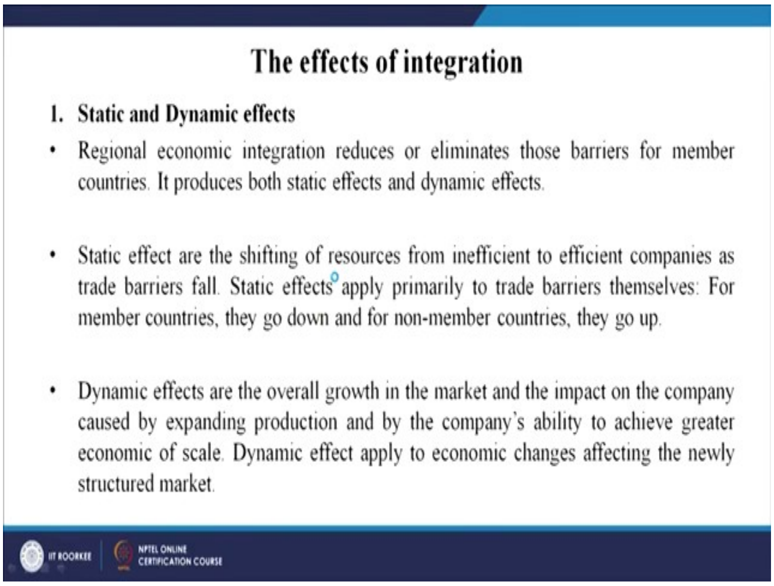

Now, what is the effect of this integration? Is it all the time good or it has some adverse effects also that needs to be discussed. So, when we talk about the effects of integration. So, it is set to be 2 types of you know effects. One is the static effect and the dynamic effect. Now, what it says? Regional economic integration reduces or eliminates those barriers for member countries. It produces both static effects and dynamic effects.

What is the static effect? Static effects are the shifting of resources right; when you shift the resources from inefficient to efficient companies as trade barriers fall ok. As the trade barriers fall, from an inefficient to a efficient company we move on the resources. Static effects apply primarily to trade barriers themselves. For member countries, they go down and for non-member countries they go up.

What is the dynamic effect? Dynamic effects are the overall growth in the market and the impact on the company caused by expanding production and by the company's ability to achieve greater scale of economy right. Dynamic effect applies to economic changes affecting the newly structured market.

So, if you see the difference if you are try to understand. In static what is happening? Just the resource is moving from one thing to the other right from an inefficient to the efficient; in dynamic what is happening? The companies are achieving a larger market and there is a higher economies of scale being applied right.

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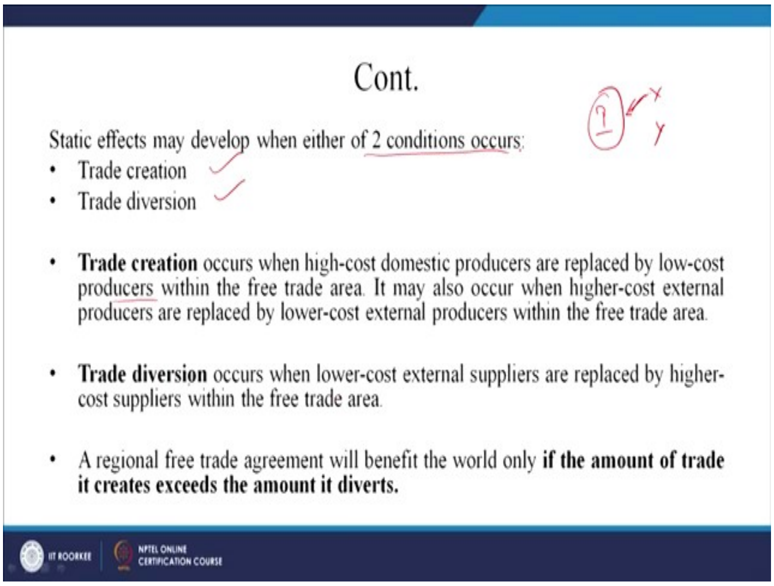

So, static effects may develop 2 conditions right. Trade creation and trade diversion; now what is this trade creation? Trade creation occurs when high cost domestic producers; that means, a company in India which is producing may be at a very high-cost are replaced by low cost producers within the free trade area, let us say tomorrow we have a free trade area between let us say India and two other countries x and y.

Now, if suppose the cost of production is very high in India; we can import these goods from we can get these goods from x or y whatever it is if that is a low cost producer. It may also occur when higher cost internal producers external producers are replaced by the lower cost external product producers within the free trade area. So, it is basically who produces the in the lowest cost within the free trade area.

The next is trade diversion, this occurs when lower cost external suppliers right are replaced by higher cost suppliers within the free trade area. So, these are some of the effects that can happen because of the integration.

A regional free trade agreement will benefit the world only if the amount of trade it creates exceeds the amount it diverts; because diversion obviously, is not going to you know help, because you simply saw that the lower costs external supplier is being replaced by a higher cost supplier within the trade area. So, this is not a desirable thing. So, the amount of trade should exceed the amount it diverts.

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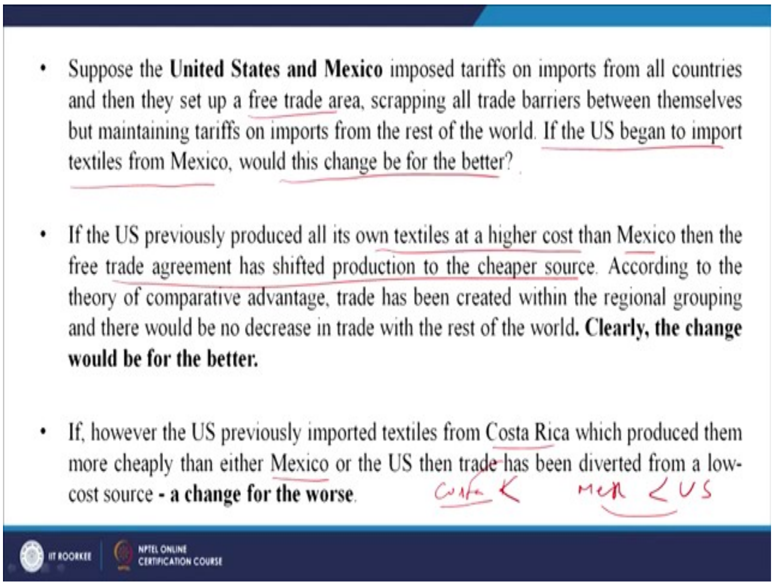

Let us say this take this example, United States and Mexico imposed tariffs on imports right they imposed tariffs on the imports from all countries and then they set up a free trade area, scrapping all the trade barriers between themselves but maintaining tariffs with the rest of the world. So, they have removed that barriers within themselves, but they have maintained the tariffs to the rest of the world.

Now, if the US began to import textiles from Mexico, would it create any advantage? That is the question right. If the US previously produced all its own textiles at a higher cost than Mexico suppose then, the agreement has shifted production to the cheaper source; that means, Mexico is a cheaper source so, it has shifted.

According to the theory of comparative advantage Ricardo's theory, trade has been created within the regional grouping and there would be no decrease in trade with the rest of the world. Clearly the change would be for the better right. So, if you have an absolute advantage in both what Ricardo had said then, still you have to go for one in which you have a specific skill or a specialization you have a specialization.

But if however, the US previously imported textiles from let us say Costa Rica which produced them more cheaply than Mexico or the US then trade has been now diverted from a low cost source to a higher cost. I hope this is clear. So, this is the case of a diversion. So, now Costa Rica was supplying at a much lower rate and Mexico was you know Costa Rica is the lowest, Mexico is then and then US.

Suppose, the earlier days US was getting the textile from Costa Rica; now because of the free trade agreement they are getting it from Mexico. So, in this case we are not getting it from the cheapest supplier right or the cheapest source. So, that is what is not a very good effect.

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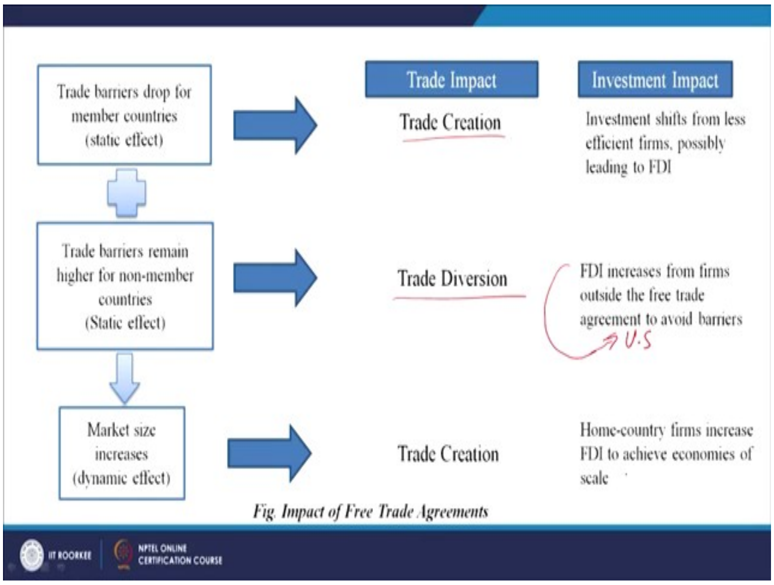

Let us say how it let us see this. Trade barriers drop for the member countries static effect. So, only the member countries the trade barriers have dropped, plus trade barriers remain higher for the non-member countries in case of a static effect. Now, market size increases, this is a dynamic effect.

Now, let us see what happens. What is the impact? So, when the trade barriers drop for the member countries trade creation happens right because; obviously, the barriers have dropped, but since the you know non-member countries you have created a higher barrier. Now, trade is being diverted as the case of Costa Rica and Mexico you saw, that Costa Rica was the cheapest supplier, but then the trade has diverted now from the cheapest to the second best right which is Mexico.

So, in this case what happens? What is the impact? So, in the first case when you saw that when trade barriers dropped trade creation happened investment shifts from the less efficient firms possibly leading to FDI right. So, in this case investment may shift from the less efficient firms possibly to the leading to the FDI; that means, Mexico can set up a plant in US; that means, right.

In the next case when there was a trade diversion what happened? FDI increases from firms outside the free trade area agreement to avoid barriers. Now, Costa Rica which is not a part of the free trade agreement or area. So, they would now want to in order to avoid barriers they would try to come to the US and set up their own shop right.

In case of a dynamic effect trade creation happens; now what happens here? When the market size increases; the home country firms increase FDI to achieve economies of scale. So, this is a situation this is the impact of the free trade agreements ok.

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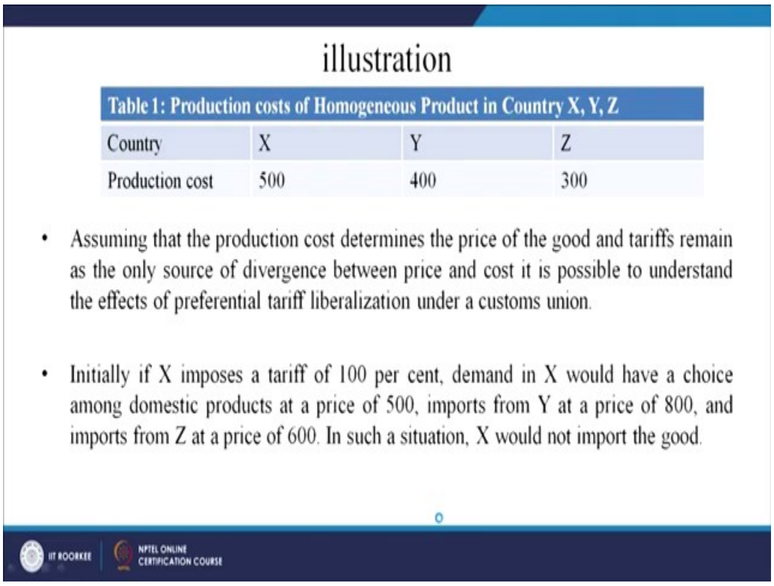

Now, take this example again the other one. So, the country there are 3 countries X, Y and Z right; and production cost is 500, 400; 300 arbitrarily it is given to you. Assume, that the production cost determines the price of the good and tariffs remain as the only source of divergence between price and cost it is possible to understand the effects of preferential tariff liberalization under a customs union.

Initially suppose if X imposes a tariff of 100 percent right. So, what happens? Demand in X would have a choice among domestic products at a price of 500 or import from Y at a price of 800 and imports from Z at a price of 600.

Because it has 100 percent is the tariff. So 400; so it has doubled 100 percent plus 400 plus 400 800. 300 plus 300 is 600. So, in such a situation X would not import the good because, now the domestic one is getting cheaper right. Suppose, if X and Y form a customs union. So here X and Y these two, they form a customs union.

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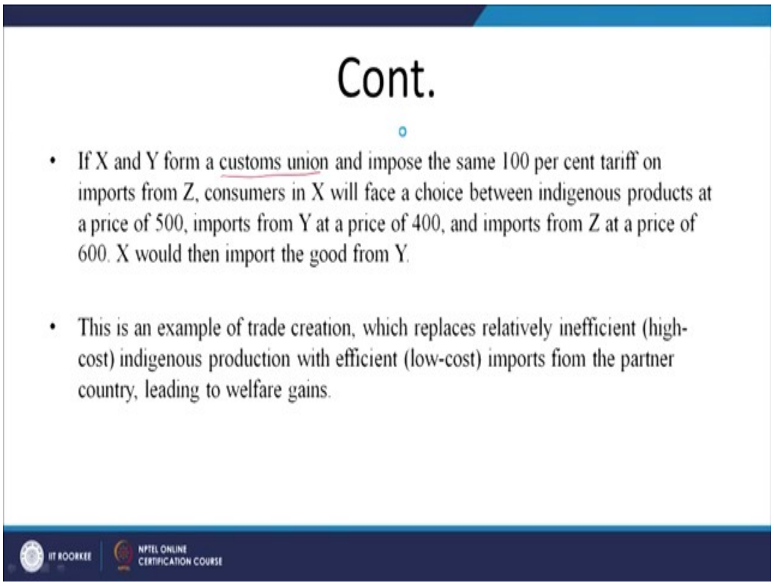

And impose the same hundred percent tariff on imports from Z right. So, consumers in X will face a choice between indigenous products at a price of 500 or imports from Y at a price of 400 right and imports from Z at 600. So, X would then obviously, imported from Y.

So, because now Y is can sell at 400 there is no import duty. So, it is selling at 400; so X would buy at 400 right. This is an example of trade creation right; which replaces the relatively inefficient indigenous production which is that 500 with efficient low cost imports from the partner country, leading to welfare gains.

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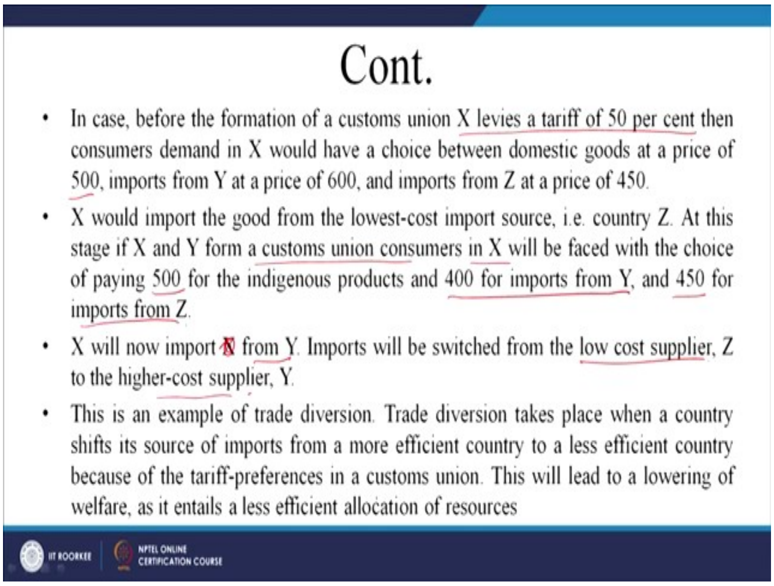

Now, let us take the same case and continue with it; in case before the formation of the custom union X levies a tariff of 50 percent, then what happens? Consumers demand in X would have a choice between domestic goods at a price of 500 or imports from Y at a price of 600.

Why 600? 400 plus 50 percent duty right which is 200. So, 400 plus 200 Y becomes 600, and imports from Z at a price of 450 why? Again it was 300 so plus 50 percent; so that makes, 300 plus 150; so 450.

Now, in this case what happens? X would import the good from the lowest-cost import source that is country Z right. So, that was Costa Rica for our case. At this stage if X and Y form a customs union consumers in X will be faced with the choice of paying 500 for the indigenous product and 400 for imports from Y and 450 for imports from Z.

Now, in this case what is happening? X will now import from Y right. Imports will be switched from the low-cost supplier right, Z to the higher-cost supplier, Y; now although, you have an agreement, but because of this now this is 450; so the movement of the good has switched from the lowest cost supplier to the higher cost supplier right. So, this is an example of trade diversion ok.

So, trade diversion takes place when a country shifts its source of imports from a more efficient country to a less efficient country right; because of the tariff-preferences in the customs union. This will lead to a lowering of welfare, as it entails a less efficient allocation of resources.

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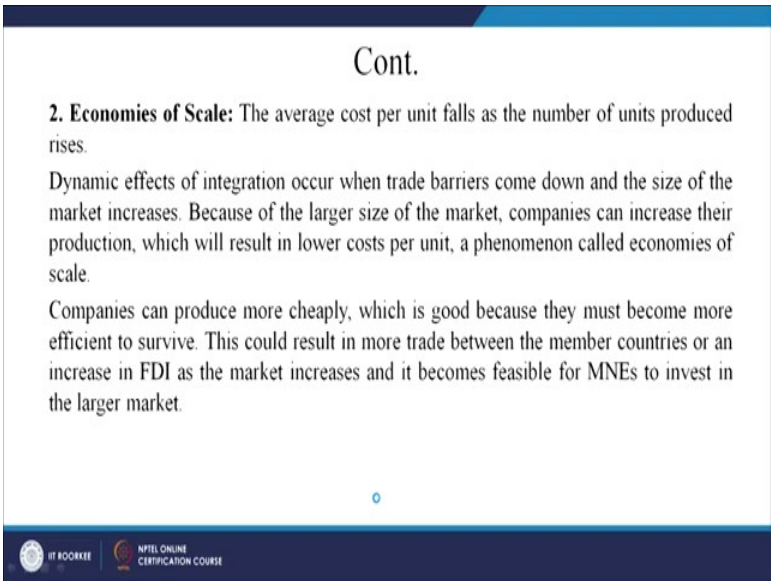

Now, with the third case the second which is the dynamic effect; what happened? There is a economies of scale. So, the average cost per unit falls as the number of units produced rises. So, dynamic effects of integration occur when trade barriers come down and the size of the market expands. Because of the larger size of the market, companies can increase their production, which will result in lower cost per unit, a phenomena called economies of scale.

So, companies can produce more cheaply, which is good because they must become more efficient to survive. This could result in more trade between the member countries or an increase in FDI as a market increases and it becomes feasible for MNEs the multinationals to invest in the larger market.

So, what it says is as the market expands; obviously, the scope for you know FDI also increases because, now companies in order to survive will have to produce at a much lower cost and they can do that also because they are getting a larger market.

So, on terms of the volume because of the larger volume they can go for a higher you know lower price by increasing this scale of economy right; and lowering the price.

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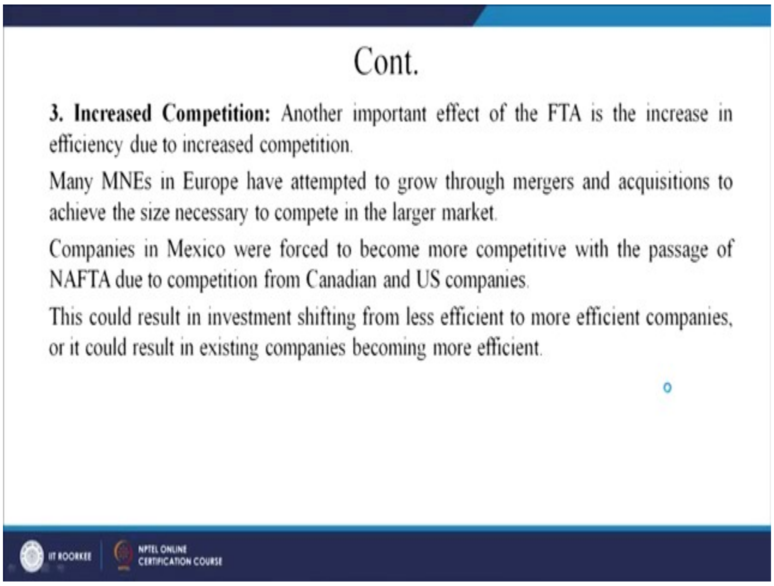

Increased competition, another important effect of the free trade agreement is the increase in efficiency due to increased competition. Many MNEs in Europe have attempted to grow through mergers and acquisitions to achieve the size necessary to compete in the larger market. So, what has happened? Because of this free trade you know agreements.

Its competition has increased. And in order to for survival what companies have done through reduce the inefficiency they have tried to merge and acquire other companies and try to be as lean as possible; by although the size has increased, but their efficiencies would increase because the asset values grow right.

So, companies in Mexico were forced to become more competitive with the passage of NAFTA due to competition from Canadian and US companies right. So, this could result in investment shifting from less efficient to more efficient companies or it could result in existing companies become more efficient; either you become efficient or you merge with other companies or you get taken over by other companies which are more efficient. So, in the overall run what happens is everybody gains ok.

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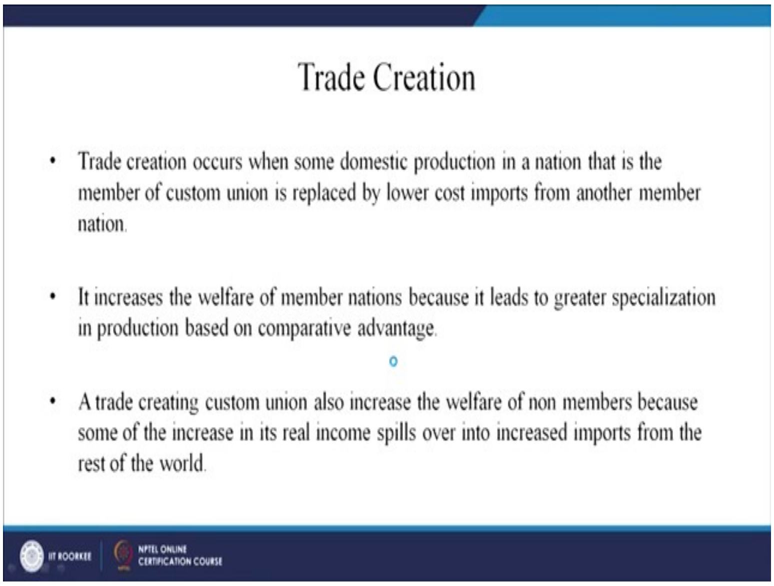

So, trade creation we have discussed right trade creation occurs when some domestic production in a nation or in the member of a custom union replaced by a lower cost imports from another; so we just saw this example. So, what is the benefit of this trade creation? It increases the welfare of the member nations because it leads to greater specialization in production.

So, a country which is doing good, it will create it will do more of that. So, the efficiency goes to the low cost producer. A trade creating custom union also increase the welfare of the non-members because, some of the increase in its real income spills over to the increased imports from the rest of the world. But that is we cannot say exactly how much this can be counted right, but that also is a benefit to the non-importing or the non-member countries.

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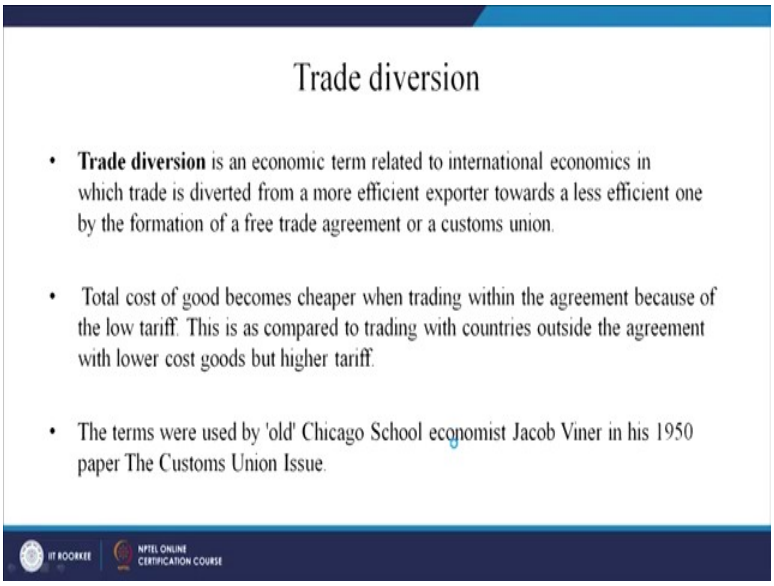

We will stop here with this last slide. So, the other point we talked about is a trade diversion. So, trade diversion we understood as an economic term related to internal economies in which trade is diverted from a more efficient exporter.

So, we saw that when it came to Costa Rica, Mexico and US towards a less efficient one. So, Costa Rica was the lowest producer of textiles cost you know producer. Now, although, it was lowest cost, but we moved it to Mexico just because we were a member country right.

So, but the formation of a free trade agreement or a customs union. The total cost of the goods become cheaper when trading within the agreement because of the low tariff. So, the tariff played a important role and because of the low tariff; now Mexico become cheaper and in then Costa Rica.

This is as compared to trading with countries outside the agreement with lower cost goods, but higher tariff. The terms were used by old Chicago school economist Jacob Viner in his 1950 paper, the customs union case right. So, I will wind up here will continue from here in the next lectures.

So, today we just have tried to understand what is this economic integration, why economic integration is important because, if you remember at this very moment when you know all countries they are weighing up to increase their trade right.

So, for example, the whole purpose of the US presidents coming to India; besides, it is political mileage that it would want to take from the Indians living in America. I also wants to have a much better trade policy where both India and US can gain because, we have seen that through Adam smith's theory, Ricardo's theory and many other economists theory, that the point is whenever trade happens; every country tends to gain right; however, we may criticize, but there is a chance that countries would gain right.

So, in order to do that; so it becomes very important that if our trade barriers and you know the tariff and non-tariff barriers are low, the countries would do better because the market becomes like one common market right. So, that is why regional economic integrations have played a very vital role in improving the trade conditions among member nations. So, this is all for today, we will continue in the next lecture.

Thank you very much.