24 ECONOMIC INTEGRATION

24.1 Forms of economic integration

Chapters 20–23 discuss the theories and the realities of free trade in the world today. Economists tend to believe that trade is generally beneficial for those nations that participate in it. Of course, there are always losers whenever nations engage in exchanges of goods and services but, in most cases, the gains of trade for society outweigh the costs.

The European Free Trade Area is one of many such trading blocs meant to promote the free flow of goods and services between nations.

Free trade based on the principle of comparative advantage is an ideal that would promote maximum allocative efficiency of the world's scarce resources. Unfortunately, it is an ideal that is far from being achieved. Since the industrial revolution and the end of colonialism, the *status quo* for most of the world's nations is generally protectionist and anti-trade.

During much of the 20th century, many of the world's economies were ideologically aligned in opposing camps, divided by the Iron Curtain into capitalist and communist systems. But, on the break-up of the Soviet Union, the ideological battle seemed to end as the vast majority of nations pursued free market reforms in an effort to promote long-run economic growth and development in their economies.

However, while free market reforms have prevailed within nations and trade has flourished among the citizens of the emerging market economies, free trade between nations has grown more slowly than many would have hoped. Nations often act out of the fear of losing current industry, rather than seeing the opportunities and benefits of open trade. And so they resist further economic integration.

The hesitancy among nations to open their borders to international trade has led to the need for clearly articulated agreements between nations as a precursor to economic integration. Trading blocs represent arrangements between two or more nations through which tariffs, quotas, and other barriers to trade of most goods and services are either reduced or eliminated altogether. Trading blocs may take several forms and can be categorized by the stages of economic integration achieved. The lowest stage represents the first steps between two or more nations at integrating their economies, while the highest stage is complete economic integration.

A trading bloc is an agreement between governments of two or more nations where regional barriers to trade (tariffs, quotas and non-tariff barriers) are reduced or eliminated in the participating states.

Levels of economic integration

Completely free trade between nations is the ideal but, in reality, countries tend to take small steps towards eliminating barriers to trade between one another. The types of trading bloc nations may enter into with other nations are, in order of level of economic integration:

- preferential trade agreement
- free trade area
- customs union
- common market
- economic and monetary union
- complete economic integration.

These trading blocs can be either bilateral (between two nations) or multilateral (between more than two nations). Typically, preferential trade agreements are agreed between two nations or between a group of nations that are part of a free trade area and another nation. At the other end of the scale, there is only one major economic and monetary union in the world today – the eurozone: European nations using a common currency, the euro. However, several economic and monetary unions are in various stages of proposal and development.

24.2 Preferential trade agreements

Learning outcomes

- 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.

Preferential trade agreement

A preferential trade agreement (PTA) is when two or more countries reduce or remove tariffs on particular goods or services produced in participating countries, or make other agreements reducing the barriers to free trade between the nations. This is the first stage of economic integration, and differs from higher stages in that not all goods are necessarily exempt from tariffs, nor must tariffs be eliminated completely on the goods included.

The term 'preferential' points to the fact that when nations sign up to such an agreement, the result is that one nation ends up preferring to buy goods and services from the other rather than from countries not included in the agreement. Preferred trade differs from free trade in that the trade is clearly not free since tariffs are not completely eliminated on all goods and services, and tariff reductions only apply to select nations, not all of a country's trading partners. Therefore, PTAs result in increased trade between participating nations at the expense of trade with the rest of the world. PTAs fall short of achieving an efficient allocation of resources, even between their members.

PTAs can be either bilateral or multilateral. Table 24.1 shows some contemporary PTAs.

TABLE 24.1 PREFERENTIAL TRADE AGREEMENTS

Name of PTA	Countries involved	Coverage	Year created
Asia Pacific Trade Agreement	Bangladesh, China, India, Lao People's Democratic Republic, Republic of Korea, Sri Lanka	Goods only	1976
Latin American Integration Association (LAIA)	Argentina, Bolivarian Republic of Venezuela, Bolivia, Brazil, Chile, Colombia, Cuba, Ecuador, Mexico, Paraguay, Peru, Uruguay	Goods only	1981
Lao PDR–Thailand	Lao People's Democratic Republic; Thailand	Goods only	1991
Economic Cooperation Organization (ECO)	Afghanistan, Azerbaijan, Islamic Republic of Iran, Kazakhstan, Kyrgyz Republic, Pakistan, Tajikistan, Turkey, Turkmenistan, Uzbekistan	Goods only	1992
Melanesian Spearhead Group (MSG)	Fiji, Papua New Guinea, Solomon Islands, Vanuatu	Goods only	1994
South Asian Preferential Trade Arrangement (SAPTA)	Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, Sri Lanka	Goods only	1995
Chile–India	Chile; India	Goods only	2007

Two of the agreements in Table 24.1 are bilateral, many are multilateral. Some PTAs are regional (such as ECO), others include nations in very different geographical locations (Chile–India). All the agreements involve reductions in or removal of tariffs on selected goods. Services are not included in any of these PTAs.

A PTA represents a step towards free trade but it must be noted that it is a rather small step. Such a pact between two or more nations promotes increased integration of the small number of countries involved, but only on selected goods and at the expense of increased integration with the rest of the world's economies.

When two countries like Chile and India enter into a PTA, the reduction in tariffs on Indian goods in Chile will certainly increase the demand for Indian imports in Chile, but this may mean a decline in demand for other countries' goods. For instance, Indian rice is cheaper for Chilean consumers because of the PTA between the nations. This may mean that Chile imports more Indian rice, but also means that Chile imports less Thai rice. This is why these agreements are called preferential and not free trade agreements. Under totally free trade, Chile would import rice from the country that has the lowest opportunity cost in rice production, and this could be any country in the world. Under a PTA, Chile imports more rice from India, even if India does not have the lowest opportunity cost, simply because the tariff on Indian rice is lower than that on rice from other countries.

A preferential trade agreement is when two or more countries reduce or remove tariffs on particular goods or services produced in participating countries, or make other agreements reducing the barriers to free trade between the nations.

To what extent does a preferential trade agreement achieve the ideals of free trade? Does it seem ethical for one country to prefer a particular country in its trade relations over all the other countries with which it could potentially trade more freely?

24.3 Trading blocs

Learning outcomes

- 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.

Free trade area

A free trade area (FTA) is formed when two or more nations make an agreement to completely eliminate tariffs on most (if not all) goods and services traded between them. FTAs are at the second level of economic integration, closer to truly free trade than a PTA where tariffs are reduced or eliminated only on certain goods.

Countries in an FTA agree to eliminate tariffs on goods and/or services produced in other member countries, but maintain the right to set their own tariffs on non-member countries.

According to the World Trade Organization (WTO), there were 168 FTAs existing in 2010, some bilateral, some multilateral. Some are shown in Table 24.2 (overleaf).

Each of these FTAs requires the removal of tariffs in the member countries on goods and/or services produced in and imported from all other member countries. The intended effect of such an agreement, of course, is to allow for a more efficient allocation of resources based on the principle of comparative advantage among the member states.

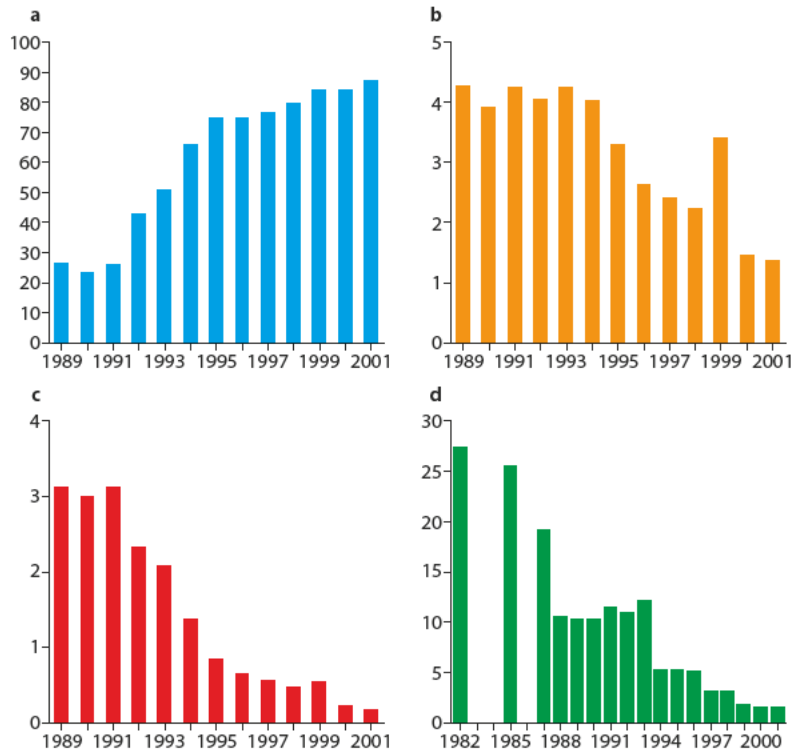
A free trade area is formed when two or more nations make an agreement to completely eliminate tariffs on most (if not all) goods and services traded between the member nations.

TABLE 24.2 FREE TRADE AREAS			
Name of FTA	**Countries involved**	**Coverage**	**Year enacted**
Australia–New Zealand (ANZCERTA)	Australia; New Zealand	Goods and services	1989
Ukraine–Russian Federation	Ukraine; Russian Federation	Goods only	1994
North American Free Trade Agreement (NAFTA)	Canada, Mexico, US	Goods and services	1994
EC–Egypt	Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovak Republic, Slovenia, Spain, Sweden, UK; Egypt	Goods only	2004
South Asian Free Trade Agreement (SAFTA)	Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, Sri Lanka	Goods only	2006
US–Morocco	US; Morocco	Goods and services	2006
ASEAN–Japan	Brunei Darussalam, Myanmar, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Philippines, Singapore, Vietnam, Thailand; Japan	Goods only	2008
China–New Zealand	China; New Zealand	Goods and services	2008
Canada–Peru	Canada; Peru	Goods and services	2009
Japan–Switzerland	Japan; Switzerland	Goods and services	2009

Evaluating the effects of a free trade agreement

The North American Free Trade Agreement (NAFTA), signed in 1994, drastically altered the structures of the three economies involved. The manufacturing sectors in the US and Canada shrank due to the reduction of tariffs on goods imported from Mexico, the country with the lowest labour costs of the three member states. The reduction in tariffs on Mexican goods imported to the US was significant, increasing the percentage of Mexican goods entering the US duty free by nearly 500% between 1990 and 2001 (Figure 24.1).

Figure 24.1
The effect of NAFTA on US–Mexico trade. **a** Share of US goods imported from Mexico entering duty free; **b** average US tariff on dutiable goods imported from Mexico; **c** average US tariff rate on total goods imported from Mexico; **d** average Mexican tariff rate.



US Congressional Budget Office, *The effect of NAFTA on US–Mexico trade and GDP*, May 2003

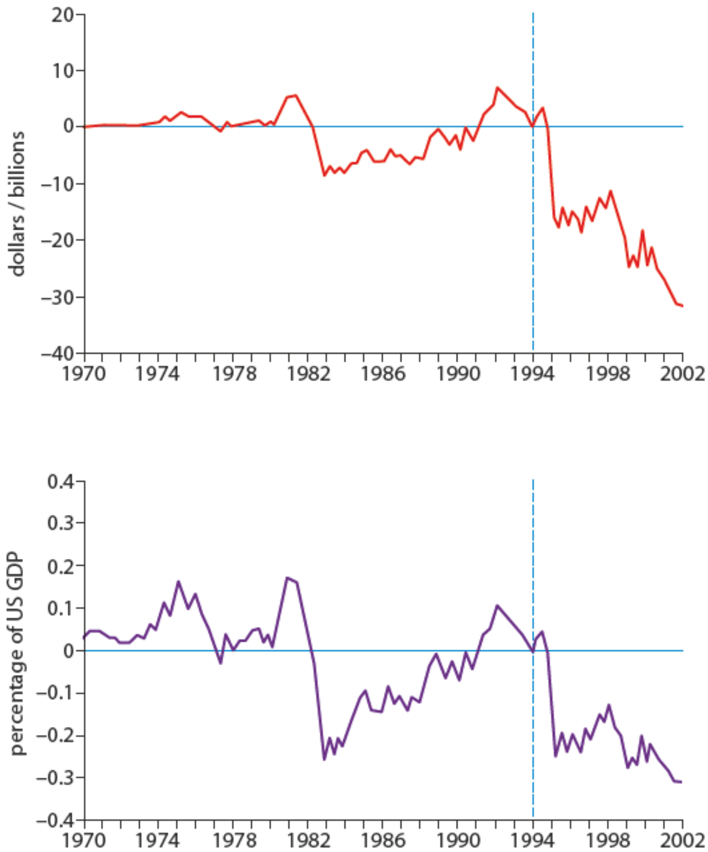
Between 1991 and 2001, the percentage of Mexican goods entering the US duty free increased from 25% to almost 90%, while the tariff rate on the few goods still taxed fell from 4% to around 1%. Mexico also reduced or removed its tariffs on US imports, the average rate declining from 12% in 1991 to around 2% in 2001.

Needless to say, not everyone in the US was thrilled with the reduction or elimination of tariffs on goods from Mexico. Many of the goods imported duty free after the signing of NAFTA were labour-intensive manufactured goods that had previously been produced in the US, including auto parts, consumer electronics and clothing. The US Congressional Budget Office defends NAFTA by arguing as follows.

The most direct economic benefits from international trade arise from the fact that countries are not all equally adept at producing the same products. The reasons they are not lie in differences in natural resources, in education levels of their workforces, in relative amounts and qualities of physical capital, in confidential technical knowledge, and so on. Without trade, each country must make everything it needs, including things it is not very efficient at producing. When trade is allowed, each country can concentrate its efforts on what it does best relative to other countries and export some of the output in exchange for imports of products it is less good at producing. As countries do that, total world output increases.

US Congressional Budget Office, *The effect of NAFTA on US–Mexico trade and GDP*, May 2003

Despite the sound economic rationale expressed in this report, opposition to NAFTA in the US continues today. Besides the shrinking effect on employment in labour-intensive industries in the US, opponents point to the effect that NAFTA has had on the US current account balance with Mexico. Figure 24.2, from the same Congressional Budget Office report, shows the US current account balance with Mexico before and after NAFTA, as well as the size of the trade deficit relative to the US GDP.



US Congressional Budget Office, *The effect of NAFTA on US–Mexico trade and GDP*, May 2003

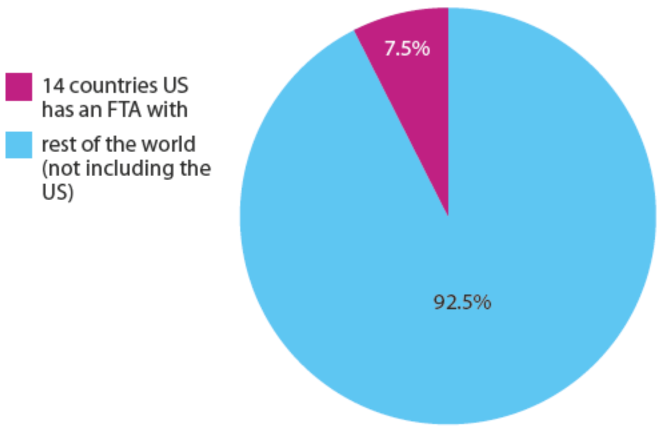
Figure 24.2
US current account balance with Mexico before and after NAFTA.

The effect of increased free trade between the US (a rich country) and Mexico (a middle-income country) could not be more clear. Spending by Americans on goods produced in Mexico grew far more rapidly after the signing of NAFTA in 1994 than US sales to Mexico did. The US current account deficit with Mexico ballooned to $35 billion (or 0.3% of US GDP) by 2001. You will remember from Chapter 23, that a trade deficit has several negative effects including depreciation of the currency (USD), declining employment in the manufacturing sector, and increased foreign (Mexican) ownership of home (US) assets (i.e. a financial account surplus).

On the other hand, the growth in imports from Mexico increased the variety of goods and services available to American consumers, and since Mexico can produce most goods at a much lower cost, the shift in the balance of trade was also accompanied by lower prices and increased real incomes among American households, who enjoyed cheaper manufactured goods due to NAFTA.

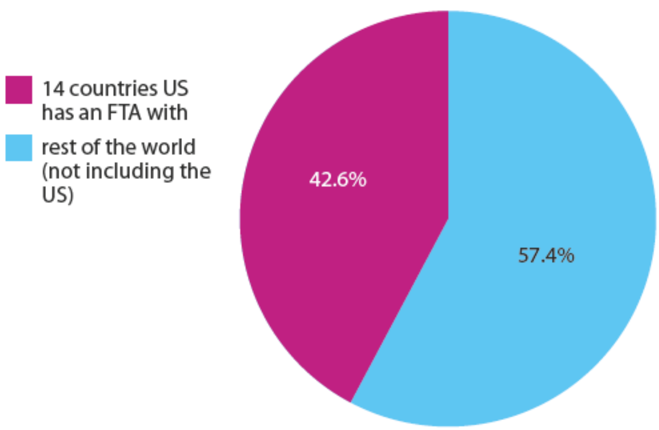
Besides NAFTA, the US is currently involved in another 13 free trade agreements. These agreements do not all harm employment in the US; in fact many US producers benefit greatly from increased free trade with the rest of the world. Figure 24.3 shows the relatively small total size of the 14 economies with which the US has free trade agreements.

Figure 24.3
Countries with which the US has free trade agreements produce 7.5% of world output.



Despite the fact that the 14 economies with which the US has free trade agreements make up only 7.5% of the world's total GDP, they make up a much larger percentage of the total demand for US exports (Figure 24.4).

Figure 24.4
Countries with which the US has free trade agreements consume 42.6% of US exports.



Countries with which the US has free trade agreements: Australia, Bahrain, Canada, Chile, Dominican Republic, El Salvador, Guatemala, Honduras, Israel, Jordan, Mexico, Morocco, Nicaragua and Singapore.

Free trade agreements like NAFTA and the 13 others the US has signed are controversial because of the effect they can have on member countries' domestic producers, but the resulting reallocation of resources between nations can have major benefits for both consumers and producers in all member nations. The US producers who were harmed by the decline in demand due to cheap imports from Mexico under NAFTA may very well have benefited due to increased demand from the 13 other countries with which the US has free trade agreements.

Free trade agreements and the FTAs they form move countries one step closer towards achieving the ideal of free trade espoused by the principle of comparative advantage.

Customs union

Next on the spectrum of economic integration is the customs union. A customs union joins member economies in an agreement whereby tariffs on all goods and services produced by one another are traded duty free, while the member nations must also agree on common duty rates on imports from all non-member countries.

To access Worksheet 24.1 on a customs union, please visit www.pearsonbacconline.com and follow the onscreen instructions.

Thus, a customs union differs from a free trade agreement in that:

- in a free trade agreement, each member nation maintains the freedom to determine the barriers to trade it will impose on imports from nations that are not part of the FTA
- in a customs union, member nations adopt common tariffs on non-member nations' goods and services.

In 2010, there were 20 customs unions in effect worldwide – a selection is shown in Table 24.3.

TABLE 24.3 CUSTOM UNIONS

Name of customs union	Countries involved	Coverage	Year enacted
East African Community (EAC)	Burundi, Kenya, Rwanda, Tanzania, Uganda	Goods only	2000
Economic and Monetary Community of Central Africa (CEMAC)	Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea, Gabon	Goods only	1999
Gulf Cooperation Council (GCC)	Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates	Goods only	2003
Eurasian Economic Community (EAEC)	Belarus, Kazakhstan, Kyrgyz Republic, Russian Federation, Tajikistan	Goods only	1997
Southern Common Market (MERCOSUR)	Argentina, Brazil, Paraguay, Uruguay	Goods and services	1991 (goods) 2005 (services)

Like a free trade agreement, a customs union improves the efficiency with which resources are allocated between member states, increases the variety of goods available in each nation, broadens the market for a nation's producers, and is likely to result in lower prices and greater employment in the economies involved. On the other hand, the common tariffs on non-member nations might divert trade away from more efficient producers in nations not included in the customs union. Such unions could, therefore, decrease overall efficiency resulting from international trade.

A customs union is an agreement between nations through which tariffs on all goods and services produced by member nations are traded tariff free, while the member nations agree on common tariff rates on imports from all non-member countries.

Common market

The fourth type of trading bloc is the common market. This is like a customs union in that goods and services are traded without tariffs but, in addition, the four factors of production flow freely between member nations. In other words, the barriers to the flow of labour, land, capital resources and entrepreneurial talent are also reduced or eliminated. The aim is to improve the allocation of resources *within* member nations and *between* them.

To access Worksheet 24.2 on trading blocs, please visit www.pearsonbacconline.com and follow the onscreen instructions.

To learn more about trading blocs, visit www.pearsonhotlinks.com, enter the title or ISBN of this book and select weblink 24.1.

The most successful example of a common market is the European Economic Area (EEA), which includes the 27 countries in the European Union plus Switzerland, Norway and Liechtenstein. Proposed common markets include the Association of South East Asian Nations and the East African Community. In order to facilitate the flow of productive resources between nations in a common market, shared regulations and policies regarding labour and capital employment must be adopted by member nations.

24.4 Monetary unions

Learning outcomes

- 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.

Monetary union

The penultimate stage of economic integration is the monetary union, which comprises a common market in which member states also adopt a common currency managed by a single central bank. A monetary union, for all intents and purposes, joins the economies of member states into one combined economy. Two examples of a monetary union are the USA (which essentially combines the economies of America's 50 states under one central bank sharing one currency, the US dollar) and the eurozone, which includes the 14 European nations that have foregone their own currencies to adopt the euro.

Monetary unions share all the characteristics of lower stages of economic integration:

- tariffs between member states are eliminated
- common tariffs on non-member nations are adopted by member states
- land, labour and capital resources may flow free of intervention between member states
- regulations regarding labour and capital are shared between member states.

A monetary union is a trading bloc in which member states eliminate all barriers to trade between them, allow for the free flow of the factors of production, adopt common tariffs on non-member states, and use a common currency managed by a shared central bank.

In addition, members abandon their monetary sovereignty and the ability to control the money supply in their own economy, since monetary policy is determined by the shared central bank. The states in the US long ago abandoned separate currencies, and, since 1913, the US money supply has been managed by the Federal Reserve. In 1999, the year in which the euro was adopted, eurozone nations lost the ability to independently determine monetary policy; it is determined by the European Central Bank, which controls the supply of the euro and thus influences interest rates among euro states.

While a monetary union represents nearly complete economic integration, the states in such a pact may maintain their fiscal sovereignty, or their ability to control their own fiscal policies, albeit with strict guidelines established by the central bank which are required to assure stability in the exchange rate of the shared currency against other currencies.

Complete economic integration

This is the final stage of economic integration, in which member states completely forego independence of both monetary and fiscal policies. The difference between the US and the eurozone is that the 50 states in the US are subject to the monetary *and* fiscal policies of the US federal government, while the eurozone nations are subject only to the monetary policies of the European Central Bank.

The US therefore represents an example of complete economic integration; but since each nation in the eurozone is free to determine its own government budget and allocate government tax revenues as it sees fit, the eurozone is not a completely integrated economy. The 14 euro nations are integrated economically and monetarily, but not fiscally. Each nation's government can decide its own fiscal policies, unlike each US state government. A group of states joined in complete economic integration essentially become one state, foregoing economic sovereignty over the majority of the economic policies and activities in the nation.

The loss of fiscal sovereignty may explain why the euro countries have thus far avoided complete economic integration; it is not yet politically viable to the culturally and socially diverse citizens of Europe to accept the sacrifice of fiscal freedom and hand over control of their governments' budgets to a federal European government.

To what extent is a nation's cultural identity dependent on its economic independence? Does joining an economic union like the eurozone require a nation to abandon some of its cultural identity?

Benefits of complete economic integration

It is worth noting that, in early 2011, the value of the euro reached its lowest level relative to other major currencies in several years. The fact that the eurozone is *not* a completely integrated economic area is the major cause for global uncertainty over the future of the currency itself. The fiscal irresponsibility of several euro nations, most notably the PIIGS (Portugal, Ireland, Italy, Greece and Spain), has threatened the stability of the euro as a globally traded currency. These five countries have, for years, run large and persistent government budget deficits, financed through the sale of government bonds to international lenders, and all have national debts that exceed 100% of their GDP.

As their debts have ballooned, the willingness of the international community to continue to finance these governments' profligate social welfare and pension programmes has waned, forcing these governments to offer higher and higher interest rates on their debt. The rise in interest rates needed to attract lenders threatens to crowd out private sector spending that is already depressed due to the global financial crisis, and to throw these economies (and their more fiscally responsible eurozone neighbours) into periods of government austerity. Such austerity will be accompanied by slow growth and a reduction in the standard of living of citizens whose governments will be forced to balance their budgets by cutting spending on social benefits and public goods of all sorts.

Under a system of complete economic integration, nations like Greece and Portugal would not be allowed to continue year after year running massive deficits and building up the level of debt they have accumulated. Had the eurozone been both a monetary *and* a fiscal union from the beginning, it is likely that the continent's current economic woes would be much less severe.

Advantages and disadvantages of economic integration

Countries that trade with other countries tend to experience increases in output, income and the standard of living of their people. From the lowest level of integration in which nations reduce tariffs on only certain products produced abroad to complete economic integration in which all barriers to trade are eliminated and monetary and fiscal policies are shared across member states, the benefits of increased economic integration are the same as those of free trade in general.

Advantages of economic integration

- **Greater efficiency.** Resource allocation is more efficient when artificial barriers to trade are eliminated and goods and services are produced in the nation with the lowest domestic opportunity cost.
- **Higher real incomes.** Cheaper imports lead to higher disposable incomes for consumers in nations that trade, improving the quality of life and the variety of goods and services available.
- **Larger export markets.** A broader consumer base allows domestic industries that are able to compete internationally to increase their output, hire more workers, and expand to meet the demands of the international marketplace.

On the other hand, increased economic integration can have some detrimental effects, which are also the disadvantages of free trade in general.

Disadvantages of economic integration

- **Fall in employment in certain industries.** Increased competition from producers abroad may force some domestic firms to shut down or move their operations overseas, reducing domestic employment.
- **Exploitation of workers.** At lower levels of economic integration in which labour regulations are not common between nations, disparities in the working conditions and wage rates between nations may create an environment in which low-skilled labour is exploited in the nations with large populations of low-income, low-skilled workers.
- **Environmental effects.** Environmental regulations may also differ between nations in a free trade area, which may cause producers to open factories in countries with the lowest standards, increasing pollution and greenhouse gas emissions overall.
- **Rising trade imbalances.** If economic integration causes a nation's imports to rise faster than its exports, then large current account imbalances between countries could result, as was the case with the US and Mexico following the signing of NAFTA.

Loss of economic sovereignty

At the higher levels of integration, such as a monetary union, member nations must give up the ability to control their own monetary policies. This reduces a country's ability to manage demand in its domestic economy by raising or lowering interest rates or manipulating the exchange rate of its currency relative to its trading partners' currencies. Since no single nation in a monetary union can determine the level of interest rates or the exchange rate on its own, control of the nation's macroeconomy is to some extent essentially handed over to a multinational central bank, a sacrifice many nations are not eager to make.

This explains why some of the nations in the EU are not currently seeking to become a part of the eurozone. Giving up its own currency prevents a country from increasing its attractiveness to foreign consumers and investors by keeping domestic interest rates low and the value of its currency weak.

24.5 Trade creation *vs* trade diversion (HL only)

Learning outcome

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

To further evaluate the effects of economic integration, we must look more closely at the impact trading blocs have on overall efficiency in the allocation of resources. In fact, it is not always the case that economic integration through bilateral or multilateral trading blocs increases *overall* efficiency in the use of the world's resources. Trading blocs do create trade between member nations, but this may come at the expense of overall efficiency if increased trade between nations causes diversion of trade from other, more efficient, lower-cost nations.

Nations that join a trading bloc experience increased trade with other nations in the trading bloc, which improves the efficiency with which resources are allocated between member nations. However, the full effect of economic integration must be examined to determine whether what results is *trade creation* or *trade diversion*. The latter occurs when a trade agreement between two or more nations diverts trade from non-member nations to member nations.

Trade creation

Trade is created if the formation of a trading bloc, bilateral or multilateral, shifts production of certain goods or services from a high-cost country to a low-cost country, thus improving efficiency, increasing the overall level of output and increasing international trade.

Take, for instance, the effect on the US television industry when NAFTA was signed. TVs had been produced in the US for decades when Mexico and the US agreed to eliminate tariffs under their free trade agreement in 1994. Since NAFTA was signed, the TV industry in the US has all but disappeared. Americans are consuming more televisions than ever, but many of those TVs are now produced in Mexico rather than in domestic factories. NAFTA created more global trade and increased the level of output of televisions as production moved from a high-cost nation (the US) to a low-cost nation (Mexico).

Trade creation is when a free trade agreement shifts production of certain goods or services from a high-cost country to a low-cost country.

Trade diversion

Trade diversion occurs if the formation of a trading bloc between two or more nations results in the production of a good or service transferring from a nation with a lower opportunity cost to one with a higher opportunity cost. Such a scenario may seem unlikely, but it occurs rather commonly at the higher levels of economic integration, such as in a customs union.

When two or more nations agree to eliminate barriers to trade between themselves, but to maintain common external tariffs on all other nations, it is possible that the result will be the diversion of trade from low-cost producers to high-cost producers.

Take, for instance, the European Economic Area (EEA), which includes the 27 countries of the EU plus Norway, Switzerland and Liechtenstein. All 30 countries in the EEA are middle- or high-income nations that have agreed to eliminate tariffs between all member nations. However, the EEA has common tariffs on non-member nations, many of which are low-income countries that may have a comparative advantage in the production of certain goods over high-income EEA nations. Due to the nature of agreement between member nations, the existence of external tariffs could increase trade between one European nation and another at the expense of trade with low-cost nations.

For example, Poland, a middle-income country with a comparative advantage in the production of intermediate manufactured goods such as auto parts, joined the EEA in 2004. As a member of the EEA, Poland enjoys duty-free exports to Germany, its largest trading partner, also a nation with a large auto industry. Germany most likely began importing more auto parts from Poland after its entry into the EEA in 2004 than it had before, since

Trade diversion occurs if the formation of a trading bloc between two or more nations results in the production of a good or service transferring from a nation with a lower opportunity cost to one with a higher opportunity cost.

What criteria can be used to assess the benefits and the costs of increased economic integration? Might increased economic integration ever be considered undesirable?

these goods could now be obtained duty free. But if this increase in trade with a middle-income European neighbour came at the expense of trade between Germany and a lower-cost non-European nation, such as China, then trade was not created, it was diverted.

Assume China had been producing auto parts at even lower cost than Poland, then Poland joined the EEA and all German tariffs on Polish goods were eliminated. Since Chinese goods are still subjected to tariffs in Germany, demand for Chinese output in Germany would fall following the elimination of tariffs on Polish goods. In this way, European economic integration under the EEA may have diverted, rather than created, international trade from a low-cost producer (China) to a higher-cost producer (Poland). When trade is diverted due to the formation of a trade bloc, overall allocative efficiency is reduced.

CASE STUDY

NAFTA keeps Mexico's economy afloat

In the global economic slump, exporting nations have suffered as incomes in Europe and North America stagnate. But Mexico is confounding the trend. In 2009, Mexico's exports shrank, but they recovered quickly in 2010, its share of the American import market growing to its highest level ever – 12.2%.

Mexico has many advantages over other exporting nations. Geographical proximity to its largest trade partner means low shipping costs despite rising oil prices. NAFTA allows Mexican imports to enter the US tariff-free, a major advantage that Chinese exporters do not enjoy. Despite Chinese producers' other cost advantages, the tariffs on Chinese goods give Mexican producers an edge in the US market. Chinese paving stones, for example, cost $5.20 per square metre compared to $5.29 for Mexican ones. But the 8.5% US tariff levied on Chinese paving stones makes them more expensive than Mexican ones. The same is true for other Mexican goods including cloth, glassware, chemicals and cars.

For over two decades, China's major advantage has been low labour costs; but this is changing – factory-workers' wages are now rising at double-digit rates. Mexico offers highly skilled labour in many industries and the wage gap with the US remains large – Mexico is increasingly appealing to American importers.

At present, 80% of Mexican exports go to the US, despite trade agreements with many other nations. One downside for the Mexican export sector is in the fine print of trade agreements with some European nations: Mexican goods entering Europe tariff-free must have originated in Mexico (or the EU). But many exporters rely on parts from the US, so they do not qualify for tariff-free access to European markets. However, as Mexican parts manufacturers expand, this may change and new markets open to Mexican exporters.

Sixteen years after NAFTA was signed, Mexico has benefited greatly from its free trade relationship with the US. But for its exporters (and the millions of workers they employ) to benefit from further trade with Europe and reduce their dependence on the American market, Mexican industry must produce more of the parts that go into the finished products.

HL EXERCISES

1. According to the case study above, how does Mexico's ability to export paving tiles tariff-free to the US benefit Mexico? How does it harm China?
2. Would you describe the effect of NAFTA on trade between the US, Mexico and China as an example of trade creation or trade diversion? Use evidence from the case study to support your answer.
3. Why is Mexico not able to take full advantage of its free trade agreements with countries other than the US (e.g. the EU)? What does the article suggest as a strategy for Mexico to begin enjoying the full gains of its existing free trade agreements?
4. How will continued economic integration help Mexico? Discuss the impact of FTAs on Mexican firms and Mexican households.

PRACTICE QUESTIONS

1 **Item 1** **South American trading bloc under pressure**

Only a few months ago, MERCOSUR, South America's main **trading bloc**, looked to be near collapse. Argentina called for sanctions against the many firms that were closing their factories and rushing to Brazil, attracted by big subsidies and a devalued currency. Brazil for its part was threatening to take Argentina to the World Trade Organisation over the import quotas that Argentina had imposed against 'dumped' textile exports.

MERCOSUR went through a difficult time when the region slipped into recession in 1998, and intra-bloc trade slumped. It nearly collapsed after the January 1999 devaluation of the Brazilian currency made Argentina's goods up to 40% dearer in their largest market. Brazil has since recovered from recession, helping Argentina: in the first three months of this year, Argentina clocked up a trade surplus with Brazil of $300 million. Even so, Argentina has been struggling to pull out of the recession, in part because the new government raised taxes in December in an effort to help cut the fiscal deficit.

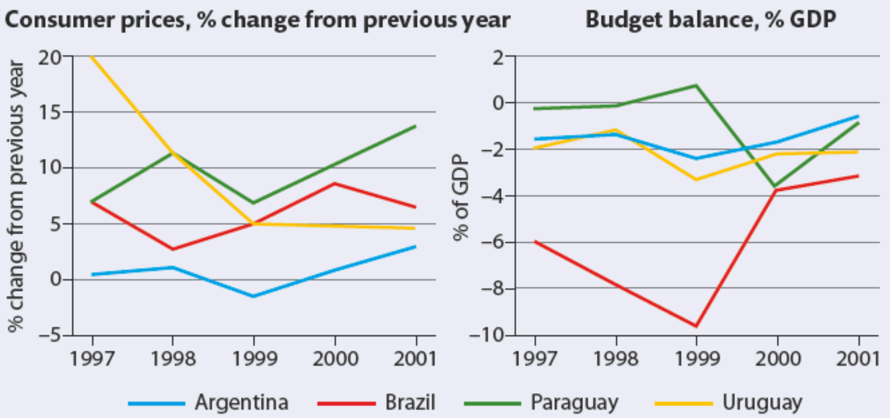
But hysteria has given way to common sense. Argentina and Brazil have agreed to bring their economies into closer harmony. They have set a timetable for a set of **economic-convergence** targets similar to those in the Maastricht treaty that led to the euro. The first targets will cover public debt, government borrowing and inflation. Others, such as the balance of payments, may come later. In the long term, the aim is supposed to be a common currency.

Where does that leave MERCOSUR's smaller members? Shut out of a market dominated by the giants, Uruguay has so far refused to back the Argentine–Brazil car deal, which imposes a 35% tariff on non-MERCOSUR cars from 2006.

Further progress is likely to depend on economic performance. Meeting the convergence targets will involve keeping to unpopular austerity programmes, and approving difficult domestic reforms. Neither Argentina nor Brazil may find that very appealing.

adapted from *The Economist*, 27 May 2000

Item 2



graphs from The Economist Intelligence Unit

a Define the following terms that appear in bold in the text:

i trading bloc (2 marks) [A01]

ii economic convergence. (2 marks) [A01]

b At one point, MERCOSUR came close to falling apart. Briefly explain why this was happening. (4 marks) [A02]

c Using an appropriate diagram, explain the effects on various stakeholders of the common tariff on non-MERCOSUR cars that was being proposed by Argentina and Brazil. (4 marks) [AO2], [AO4]

To access Quiz 24, an interactive, multiple-choice quiz on this chapter, please visit www.pearsonbacconline.com and follow the onscreen instructions.

d Using the data and your knowledge of economics, evaluate the degree to which trading blocs increase efficiency and move the global economy toward free trade. (8 marks) [AO3]

2 **Protecting shrimp farmers**

The USA has started talks with Thailand on a **free trade area**.

The US International Trade Commission (ITC) has said it has evidence to suggest that Thailand and five other Asian countries were selling shrimps at below market prices, and gave a warning that it might impose tariffs. This threatens to complicate the free trade talks expected to start soon.

The tariffs are being demanded by the Southern Shrimp Alliance that represents thousands of shrimp catchers from the USA. The alliance is seeking tariffs up to 349% on imported shrimps. Critics of this action argue that it will do little to benefit struggling American shrimp catchers, while making it very difficult for small scale shrimp farmers in these Asian countries.

Thailand and the other leading shrimp exporters to the USA insist they are not **dumping**. They say their labour costs are lower and they are more productively efficient because they farm shrimp in ponds rather than fishing in the ocean as the Americans do.

If an anti-dumping ruling is successful, it is estimated that Thailand's 35 000 shrimp farmers will need to reduce output by 20–30%, and hundreds of small scale producers and feed producers will go out of business.

TABLE 1 INCREASE IN ASIA'S MAJOR SHRIMP EXPORT VALUES TO THE USA

	2002 / thousands of $	2003 / thousands of $	% Change
Thailand	399.9	445.3	11.3
Vietnam	282.9	394.4	39.4
India	293.4	327.7	11.7
China	131.6	245.3	86.4
Indonesia	118.0	141.1	19.5
Total US imports	2075.5	2460.9	18.6

TABLE 2 HOURLY LABOUR COSTS

	Shrimps / US$	Shirts / US$
Thailand	0.50	2.00
USA	17.00	26.00

adapted from 'Free Trade runs into Protectionism', Murray Heibert and Shawn W Crispin, *The Far Eastern Economic Review*, 4 March 2004

a Define the following terms indicated in bold in the text:

i free trade area (paragraph 1) (2 marks) [AO1]

ii dumping (paragraph 4). (2 marks) [AO1]

b Using an appropriate diagram, explain effect of the proposed US tariff on imported shrimp. (4 marks) [AO2], [AO4]

c Using the data in Table 2, calculate the opportunity cost of shrimps and shirts in the US and Thailand. Based on your calculation, indicate which country has a comparative advantage in the two goods. (4 marks) [AO2], [AO4]

d Using information from the text and your knowledge of economics, examine the degree to which Thailand and the US would mutually benefit from a free trade arrangement. (8 marks) [AO3]