Chapter 8
Regional Economic Integration

International Business
Strategy, Management & the New Realities

by
Cavusgil, Knight and Riesenberger

Regional Economic Integration

Growing economic interdependence that results when countries within a geographic region form an alliance aimed at reducing barriers to trade and investment.

About 40% of world trade now occurs via an economic bloc agreement.

Cooperating nations obtain:

- increased product choices, productivity, living standards;
- lower prices; and
- more efficient resource use.

Economic Bloc

A geographic area that consists of two or more countries that agree to pursue economic integration by reducing tariffs and other restrictions to cross-border flow of products, services, capital, and, in more advanced stages, labor.

Examples: European Union (EU), NAFTA, MERCOSUR, APEC, ASEAN, and many others

There are five possible levels of economic integration

Level of Integration	*Free Trade Area*	*Customs Union*	*Common Market*	*Economic and (sometimes) Monetary Union*	*Political Union*
Members agree to eliminate tariffs and non tariff trade barriers with each other but maintain their own trade barriers with non member countries. *Examples: NAFTA, EFTA, ASEAN, Australia and New Zealand Closer Economic Relations Agreement (CER)*	✔				
Common external tariffs *Example: MERCOSUR*	✔	✔			
Free movement of products, labor, and capital *Example: Pre-1992 European Economic Community*	✔	✔	✔		
Unified monetary and fiscal policy by a central authority *Example: The European Union today exhibits common trade, agricultural, and monetary policies*	✔	✔	✔	✔	
Perfect unification of all policies by a common organization; submersion of all separate national institutions *Example: Remains an ideal; yet to be achieved*	✔	✔	✔	✔	✔

Exhibit 8.1

Five Potential Levels of Regional Integration among Nations

Levels of Regional Integration

1. **Free trade area**: Simplest, most common arrangement. Member countries agree to gradually eliminate formal trade barriers within the bloc, while each member country maintains an independent international trade policy with countries outside the bloc. E.g., NAFTA.

2. **Customs union**: Similar to a free trade area except that the members harmonize their trade policies toward nonmember countries, by enacting *common* tariff and nontariff barriers on imports from nonmember countries. E.g., MERCOSUR (mainly Argentina, Brazil, Paraguay, and Uruguay)

Levels of Regional Integration (cont'd)

3. **Common market** (single market): Like a customs union**,** except products, services, and *factors of production* such as capital, labor, and technology can move freely among the member countries. E.g., the EU. requires much cooperation among the member countries on labor and economic policies.

4. **Economic union**: Like a common market, but members also aim for common fiscal and monetary policies, standardized commercial regulations, social policy, etc. E.g., the EU is moving toward economic union by forming a *monetary union* with a single currency, the euro.

Levels of Regional Integration (cont'd)

5. Political union

- Perfect unification of all policies by a common organization. Submersion of all separate national institutions.
- Remains an ideal, yet to be achieved.

Members	*Population (millions)*	*GDP (US$, billions, PPP terms)*	*GDP per capita (US$; PPP terms)*	*Exports as a percentage of GDP*
Austria	8	$299	$36,189	29%
Belgium	10	353	33,908	52
Bulgaria	8	83	10,844	16
Cyprus	1	20	23,419	7
Czech Republic	10	210	20,539	44
Denmark	5	204	37,398	26
Estonia	1	26	19,243	36
Finland	5	179	34,162	29
France	63	1,988	31,377	17
Germany	83	2,699	32,684	26
Greece	11	274	24,733	3
Hungary	10	190	18,922	42
Ireland	4	192	45,135	53
Italy	59	1,791	30,383	17
Latvia	2	34	15,062	21
Lithuania	3	57	16,756	36
Luxembourg	0.5	35	76,025	28
Malta	0.4	8	21,081	44
The Netherlands	17	550	33,079	44
Poland	38	557	14,609	24
Portugal	11	218	20,673	18
Romania	22	219	10,152	51
Slovakia	5	101	18,705	67
Slovenia	2	49	24,459	38
Spain	42	1,203	28,810	16
Sweden	9	297	32,548	30
United Kingdom	61	2,004	32,949	14
	Total: 491	Total: $13,840		

Exhibit 8.4 Key Features of the European Union Member Countries, 2007

SOURCE: International Monetary Fund at www.imf.org

The EU: Features of a Full-Fledged Economic Union

1. ***Market access.*** Tariffs and most nontariff barriers have been eliminated.
2. ***Common market.*** Removed barriers to cross-national movement of production factors—labor, capital, and technology.
3. ***Trade rules***. Eliminated customs procedures and regulations, streamlining transportation and logistics within Europe.
4. ***Standards harmonization.*** Harmonizing technical standards, regulations, and enforcement procedures on products, services, and commercial activities.
5. ***Common fiscal, monetary, taxation, and social welfare policies***, in the long run.

Four Institutions that Govern the EU

Council of the European Union. The main decision-making body. Makes decisions on economic policy, budgets, and foreign policy, and admission of new member countries.

European Commission. Represents the interests of the EU as a whole. Proposes legislation. Responsible for implementing decisions of the Parliament and the Council.

European Parliament. Up to 732 representatives. Hold joint sessions each month. Three main functions:

1. Devise EU legislation,
2. Supervise EU institutions, and
3. Make decisions on the EU budget.

European Court of Justice. Interprets and enforces EU laws and settles legal disputes between member states.

The European Union Today

- 27 members. Bulgaria, Romania joined in 2004.
- New members – e.g., Poland, Hungary, Czech Republic – are low-cost manufacturing sites.
  - Peugeot, Citroën (France) – factories in Czech Rep.
  - Hyundai (South Korea) – Kia plant in Slovakia.
  - Suzuki (Japan) – factory in Hungary.
- Most new EU entrants are one-time satellites of the Soviet Union, and have economic growth rates far higher than the 15 Western European counterparts.
- Developing economies – e.g., Romania, Bulgaria – may take decades of foreign aid to catch up

NAFTA (Canada, Mexico, the United States)

NAFTA passage (1994) was facilitated by the *maquilladora* program, in which U.S. firms located manufacturing plants just south of the U.S. border to access low-cost labor without significant tariffs. NAFTA has:

- Eliminated tariffs and most nontariff barriers for products/services.
- Established trade rules and uniform customs procedures.
- Instituted investment rules and intellectual property rights
- Provided for dispute settlement for investment, unfair pricing, labor issues, and the environment.

Exhibit 8.5 North American Free Trade Agreement (NAFTA), 2007

SOURCE: International Monetary Fund at www.imf.org

Members	*Population (millions)*	*GDP (US$ billions, PPP terms)*	*GDP per capita (US$; PPP terms)*	*Exports as a percentage of GDP*
Canada	33	$1,225	$37,321	29%
Mexico	108	1,192	10,993	18
United States	302	13,678	45,257	6
	Total: 443	Total: $16,095		

NAFTA Results

- Trade among the members more than tripled; now exceeds $1 trillion per year.
- In the early 1980s, Mexico's tariffs averaged 100% and gradually disappeared under NAFTA.
- Both Canada and Mexico now have some 80% of their trade with, and 60% of their FDI stocks in the United States.

How the Mexican Economy Benefited from NAFTA

- Mexican exports to the U.S. grew from $50 billion to over $160 billion per year.
- Access to Canada and the U.S. helped launch many Mexican firms in industries such as electronics, cars, textiles, medical products, and services.
- Yearly U.S. and Canadian investment in Mexico rose from $4 billion in 1993 to nearly $20 billion by 2006.
- Mexico’s per capita income rose to about $11,000 in 2007, making it the richest country in Latin America.

El Mercado Comun del Sur (MERCOSUR)

- Launched in 1991.
- Strongest economic bloc in South America
- The four largest members alone (Argentina, Brazil, Paraguay, and Uruguay) account for about 80% of South America's total GDP.
- Established free movement of products and services, common external tariff and trade policy, coordinated monetary and fiscal policies.
- May be integrated with NAFTA and DR-CAFTA as part of the proposed Free Trade Area of the Americas (FTAA), bringing free trade to all the western hemisphere.

Members	*Population (millions)*	*GDP (US$ billions, PPP terms)*	*GDP per capita (US$; PPP terms)*	*Exports as a percentage of GDP*
Argentina	39	$599	$15,509	6%
Brazil	189	1,758	9,286	5
Paraguay	6	32	5,264	9
Uruguay	3	38	12,012	4
Venezuela	28	182	6,614	18
Bolivia *	10	28	2,858	7
Chile *	17	225	13,588	12
Colombia *	48	380	7,975	5
Ecuador *	14	62	4,591	13
Peru *	29	190	6,609	6
	Total: 383	Total: $3,494		

* Associate members

Exhibit 8.6 El Mercado Comun del Sur (MERCOSUR), 2007

SOURCE: International Monetary Fund at www.imf.org

Others

- Caribbean Community and Common Market (CARICOM)
- Comunidad Andina de Naciones (CAN)
- Association of Southeast Asian Nations (ASEAN)
- Asia Pacific Economic Cooperation (APEC)
- Australia and New Zealand Closer Economic Relations Agreement (CER)

Why Nations Pursue Economic Integration

1. Expand market size

- Greatly increases the scale of the marketplace for firms inside the economic bloc. E.g., Belgium has a population of just 10 million; the EU has a population of nearly 500m.
- Consumers can access much bigger selection of products and services.

2. Achieve scale economies and enhanced productivity

- Bigger market facilitates economies of scale
- Internationalization inside the bloc helps firms learn to compete more effectively outside the bloc.
- Labor and other inputs allocated more efficiently among the member countries, leading to lower consumer prices.

Why Nations Pursue Economic Integration (cont'd)

3. Attract investment from outside the bloc

Compared to investing in stand-alone countries, foreign firms prefer to invest in countries that are part of an economic bloc. E.g., General Mills, Samsung, and Tata invested heavily in the EU.

4. Acquire stronger defensive and political posture

Provide member countries with a stronger defensive posture relative to other nations and world regions, an original motive of the EU

What Factors Contribute to the Success of Regional Integration?

1. ***Economic similarity***. The more similar the economies of the members, the more likely the bloc will succeed (e.g., wage rates, economic stability). E.g., EU.

2. ***Political similarity***. Similarity in political systems is key. Countries should share similar aspirations and a willingness to surrender national autonomy. E.g., EU.

3. ***Similarity of culture and language***. Helpful, but not absolutely necessary. E.g., MERCOSUR, Aus/NZ CER.

4. ***Geographic proximity***. Facilitates transportation of products, labor, and other factors. Neighboring countries tend to share a common history, culture and language. E.g., NAFTA, EU.

Consequences of Regional Integration

- ***Trade creation*** – As barriers fall, trade is generated inside the bloc.
- ***Trade diversion*** – As within-bloc trade becomes more attractive, member countries discontinue some trade with nonmember countries.
- **Aggregate effect** – National patterns of trade are altered. More trade occurs inside the bloc; less trade occurs with countries outside the bloc.
- A concern: A bloc might become an 'economic fortress', leading to more *within-bloc* trade and less *between-bloc* trade; Can harm *global* free trade.

Consequences of Regional Integration (cont'd)

- **Loss of national identity**. Increased cross-border contact makes members more similar to each other. E.g., in response, Canada has restricted the ability of U.S. movie and TV producers to invest in the Canadian film and broadcasting industries.
- **Sacrifice of autonomy**. In later stages of regional integration, a central authority is set up to manage the bloc's affairs. Members must sacrifice some autonomy to the central authority, such as control over their own economy. E.g., Britain in the EU.

Consequences of Regional Integration (cont'd)

- **Transfer of power to advantaged firms**. Can concentrate economic power in the hands of fewer, larger firms, often in the most advantaged member countries.
- **Failure of small or weak firms**. As trade and investment barriers fall, protections are eliminated that previously shielded smaller or weaker firms from foreign competition.
- **Corporate restructuring and job loss**. Increased competitive pressures and corporate restructuring may lead to worker layoffs or re-assigning employees to distant locations, disrupting worker lives and entire communities.

Implications of Regional Integration for the Firm

- **Internationalization by firms inside the economic bloc**. Internationalization gets easier after reg. integration
- **Rationalization of operations**. Managers develop strategies and value-chain activities suited to the region as a whole, not individual countries, by restructuring and consolidating company operations. Goal is to reduce costs and redundancy; increase efficiencies via scale economies. E.g., firms centralize distribution, instead of decentralizing it to individual countries.
- **Mergers and acquisitions**. Economic blocs lead to M&A, the tendency of one firm to buy another, or of two or more firms to merge and form a larger firm.

Implications of Regional Integration for the Firm (cont'd)

- **Regional products and marketing strategy**. *Standardization* of products and services cuts costs. E.g., Case, a manufacturer of agricultural machinery once made 17 versions of the Magnum tractor; EU integration allowed Case to greatly reduce this number.
- **Internationalization by firms from outside the bloc**. The best way for a foreign firm to enter a bloc is via FDI (because external trade barriers mainly affect exporting). E.g., with formation of the EU, Britain has become the largest recipient of FDI from the USA.
- **Increased collaborative ventures**. Regional integration makes cross-border cooperation easier. E.g., Airbus.

Regional Economic Integration: Future Prospects

- In 1990, there were about 50 regional economic integration agreements worldwide. Today there are some 200, in various stages of development.
- Governments continue to liberalize trade policies, encourage imports, and restructure regulatory regimes, largely via regional cooperation.
- Many nations belong to several free trade agreements.
- The evidence suggests that regional economic integration is gradually giving way to a system of worldwide free trade.